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# Using Stock and Stock Options to Minimize Patent Royalty Payment Risks after *MedImmune v. Genentech*

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# USING STOCK AND STOCK OPTIONS TO MINIMIZE PATENT ROYALTY PAYMENT RISKS AFTER *MEDIMMUNE V. GENENTECH*

SEAN M. O'CONNOR\*

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## I.

### INTRODUCTION

On January 9, 2007, the Supreme Court stunned the licensing community by holding that a licensee who is enjoying all of the legal protections of the license can nonetheless de-

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stroy the underlying patent by obtaining a declaratory judgment that it is invalid, unenforceable, or not infringed. On the face of it, *MedImmune, Inc. v. Genentech, Inc.*,<sup>1</sup> is a narrow technical interpretation of the U.S. Constitution's Article III limitation of federal court jurisdiction to "cases" and "controversies," in the context of the "actual controversy" requirement of the Declaratory Judgment Act.<sup>2</sup> In practical effect, the case represents the unsettling shift in the settled expectations about patent challenges in the licensor-licensee relationship. That the apple cart has indeed been upset, so to speak, is evident in the abundant immediate offerings of professional organizations – such as the Licensing Executives Society,<sup>3</sup> and American Bar Association<sup>4</sup> – and law firms<sup>5</sup> to help practitioners and lay persons understand the implications of the *MedImmune* decision and quickly retool licensing strategies accordingly.

As discussed in more detail below, the common understanding before *MedImmune* was that licensees had to repudiate the license by ceasing royalty payments, for example, before having standing to bring a declaratory judgment action to find the licensed patent invalid, unenforceable, or non-infringed. This repudiation allowed the licensor/patent owner to bring its own patent infringement suit directly as plaintiff, or as a counterclaim as the defendant in a declaratory judgment brought by the licensee. The *MedImmune* decision seems to allow the licensee to snipe at the patent with impunity because so long as the licensee complies with its license obligations the licensor/patent owner can neither bring a direct patent infringement suit, nor counterclaim patent infringement. At the same time, the patent owner cannot effectively protect

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1. 127 S.Ct. 764 (2007).

2. 28 U.S.C. §2201(a) (2000).

3. See Press Release, Licensing Executives Society, Supreme Court Decision Will Alter Structure of Future Deals, Licensing Executives Society Says (Jan. 10, 2007), available at <http://www.usa-canada.les.org/press/archives/1.10.07.asp>.

4. See American Bar Association CLE, Potential Licensing Responses to *MedImmune*, <http://www.abanet.org/cle/programs/t07med1.html> (last visited Apr. 20, 2007).

5. See, e.g., Douglas D. Chung & Matthew J. Kleiman, WilmerHale, US Supreme Court Holds Courts May Hear Challenges by Patent Licensees, Feb. 6, 2007, <http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=3566>.

itself by contractually prohibiting the licensee from challenging the patent because such provisions are generally unenforceable under the doctrine established in cases such as *Lear, Inc. v. Adkins*.<sup>6</sup> Thus, patent owners now find themselves subject to the untenable possibility that they will be like landlords who would have to sit back and wait while a tenant tried to burn down the house for insurance money because the landlord was legally prohibited from evicting the tenant. This would be shocking as a matter of landlord-tenant law and it should be equally shocking in licensing law.

Nonetheless, keeping in mind former Justice Jackson's famous remark about the Supreme Court ("[w]e are not final because we are infallible, but we are infallible only because we are final"),<sup>7</sup> whatever one thinks about the *MedImmune* decision, it now defines the playing field for licensing relationships. Perhaps some special interest groups aligned with patent owners will successfully lobby Congress for a legislative fix to their predicament – although it is not clear what that would look like. This Article, however, proposes a more or less functional equivalent mechanism to a patent royalty stream through the use of stock and stock options in the licensee. The stock would coarsely track the overall fortunes of the licensee, while the options could be more finely tuned to vest and become exercisable upon events and milestones that would have been used for payments in a traditional license fee plus royalty stream licensing deal. There may be problems of liquidity, of course, during the period where the licensee is still privately held and thus has no ready markets for its stock. But even this could be dealt with to some extent by redemption rights or put options on the stock held by the licensor. The real value of what may seem to be a complicated replacement for the relatively straightforward royalty stream licensing arrangement is that the stock compensation system would consist of value and rights fully conveyed to the licensor upon the execution of the license agreement. Thus, any subsequent challenge to the patents and adverse finding against the licensor would not jeopardize the licensor's expected returns where the licensee successfully commercializes the underlying patent.

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6. *Lear, Inc. v. Adkins*, 395 U.S. 653, 670 (1969).

7. *Brown v. Allen*, 344 U.S. 443, 540 (1953) (Jackson, J., concurring).

Part II of the Article provides a taxonomy of license arrangements and then analyzes the complicated history of judicial debate over licenses and doctrines such as licensee estoppel and assignor estoppel. Part III discusses *MedImmune* and its implications, showing the need for a solution to minimize the new risks to royalty payments presented by *MedImmune*. Finally, the proposed solution to use stock and stock options to allow licensees to convey over to Licensor all of the equity positions required so that Licensor can exercise these in a manner that tracks the fortunes of the company is discussed in detail in Part IV.

## II.

### TAXONOMY OF LICENSES AND THE HISTORY OF PATENT CHALLENGES TO LICENSES BEFORE *MEDIMMUNE*

Intellectual property (IP), technology, and information licensing has emerged over the past few decades as the predominant manner of conveying rights and arranging business relationships in the new technological age.<sup>8</sup> In this context, a “license” can be viewed as either a grant of permission or a covenant not to sue.<sup>9</sup> It is different from a “lease” which instead conveys temporary possession and use rights to physical property to the lessee.<sup>10</sup> In both the information technology (IT) and life sciences fields, owners of proprietary technology often use a legal model I have described elsewhere as the “lease-license model” whereby a single agreement conveys both physical property rights and IP license rights.<sup>11</sup> This Article focuses primarily on the IP license side of these arrangements, although it is important to realize that the leverage of physical property rights and leases can mitigate to some extent the economic harm to the technology owner where a lessee-licensee successfully challenges an underlying patent in a declaratory judgment in the wake of *MedImmune*.

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8. XUAN-THAO N. NGUYEN ET AL., *INTELLECTUAL PROPERTY, SOFTWARE, AND INFORMATION LICENSING: LAW AND PRACTICE* 2-3 (2006).

9. *Id.* at 3-4.

10. Sean M. O'Connor, *The Use of MTAs to Control Commercialization of Stem Cell Diagnostics and Therapeutics*, 21 *BERKELEY TECH. L.J.* 1017, 1018-27 (2006).

11. *Id.*

Another way to think about the current licensing environment is to create a simple taxonomy of types of licenses based on the motivations of the parties entering into the license. The central division in my proposed taxonomy is between IP licenses that originate as settlements to IP infringement disputes ("settlement licenses") and those that originate from parties who simply have a desire to license IP as a business deal ("deal licenses"). Settlement licenses may arise from an actual litigation or from policing and enforcement activities of the IP owner such as correspondence to suspected infringers in the form of IP ownership notices<sup>12</sup> or cease and desist letters.<sup>13</sup> As in many taxonomies, the divisions are often a bit artificial and can blur at the edges. For example, an IP ownership notice sent from one company to another might trigger discussions for a more comprehensive mutually beneficial business deal (and hence a deal license) rather than a narrow IP use license that has the air of a begrudging response to a shake down (the settlement license). Nonetheless, the imperfect distinction I propose is useful as it sets the stage for a way to think about the idea of how coercive the IP owner has been in procuring the license from the licensee, a factor of importance for the Supreme Court in *MedImmune*.<sup>14</sup>

Within the realm of settlement licenses are those often drafted by litigators as part of the negotiated settlement to an actual lawsuit as well as those that may be quite formulaic and drafted by IP counsel as part of ongoing monitoring and policing of IP rights of the client generally. While much of this policing is directed at businesses, a significant amount is also directed at individuals. In some cases, the policing efforts may

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12. Generally, notices are in the form of "you should be aware that we hold the rights to U.S. Patent No. x,xxx,xxx to which you may want to enter into a license agreement with us."

13. Generally, they are in the form of "your activities are infringing our rights under U.S. Patent No. xxx,xxx and we demand that you either cease these activities or enter into negotiations with us to procure a license." Note that the full on cease and desist letter will, in almost all cases, provide a sufficient trigger for the recipient of the letter to bring a declaratory judgment action against the sender of the letter (and IP owner) to establish that the IP is either invalid, unenforceable, or not infringed. This renders the decision of when and whether to use the cease and desist letter versus the IP notice letter (or neither and simply bring a lawsuit immediately) as an important legal and business strategy decision for the IP owner.

14. See *infra* Part III(A).

seem extreme and possibly overreaching,<sup>15</sup> or even downright extortionist and fraudulent.<sup>16</sup> Where the settlement license arises in actual litigation, there should at least be some colorable basis for the IP rights asserted (else the purported IP owner's counsel may be liable for sanctions). However, where the settlement license arises simply from policing correspondence between the parties, there may be no real basis for the IP ownership or infringement claims. Thus, the latter may raise hackles and equitable concerns about their enforceability, despite the general principle of freedom to contract, as exploitive shake downs of unwary or easily intimidated smaller businesses or individuals lacking the means or stomach for what may be threatened as a protracted legal battle. Lurking in the background is the specter of so-called "patent trolls" who do not commercialize the patents they hold through manufacture or active licensing programs, but instead lie in wait for some hapless company to bring a product to market that arguably infringes some corner of the troll's patent portfolio and then – abruptly – emerge with an infringement lawsuit threatening the an injunction against the defendant company.<sup>17</sup> I suggest that it is this area of potential abuse of settle-

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15. See, e.g., The Lactivist, *Overzealous Big Pork Stomps on Breastfeeding Blogger* <http://thelactivist.blogspot.com/2007/02/overzealous-big-pork-stomps-on.html> (Feb. 1, 2007); Letter from Rochelle M. Trafton, Assoc. Counsel, Spherion Corp. to Paul Steven Miller, Professor, Univ. of Wis. Sch. of Law (Jan. 11, 2005) (on file with NYU Journal of Law & Business).

16. See, e.g., Posting of Marcel D. Mongeon, [marcelm@mcmaster.ca](mailto:marcelm@mcmaster.ca), to [techno-l@lists.uventures.com](mailto:techno-l@lists.uventures.com) (Apr. 3, 2003) (on file with NYU Journal of Law & Business); Posting of Kevin Croft, [K.Croft@blo.usyd.edu.au](mailto:K.Croft@blo.usyd.edu.au), to [techno-l@lists.uventures.com](mailto:techno-l@lists.uventures.com) (Apr. 2, 2003) (on file with NYU Journal of Law & Business); Posting of Jaconda Wagner, [Jaconda\\_Wagner@bd.com](mailto:Jaconda_Wagner@bd.com), to [techno-l@lists.uventures.com](mailto:techno-l@lists.uventures.com) (Apr. 3, 2003) (on file with author).

17. See Joe Brennan et al. *Patent Trolls in the U.S., Japan, Taiwan and Europe*, CASRIP NEWSL. (Ctr. For Advanced Study & Research on Intellectual Prop., Seattle, Wash.) Spring/Summer 2006, at 1 *available at* <http://www.law.washington.edu/Casrip/Newsletter/Vol13/news13i2BrennanEtAl.html>. Note that the troll's big stick – the threat of an injunction that could take the defendant's product entirely out of the market – has been blunted somewhat by last year's Supreme Court decision in *EBay vs. MercExchange*, 126 S. Ct. 1837 (2006), that rejected the proposition that injunctive relief should be automatically granted upon any finding of patent infringement. Instead, courts are now directed to use standard tests for whether the equities of the situation call for the extraordinary relief of an injunction. Despite this development, the threat of injunction still hangs over patent infringe-

ment licenses that plays some role in the Supreme Court's *MedImmune* decision as discussed below.

On the other side of the ledger, however, are arms-length, non-coercive deal licensees. Primary in this category are deal licenses between sophisticated businesses with experienced IP counsel (B2B deal licenses). Perhaps somewhat more controversially, I also include business to consumer deal licenses (B2C deal licenses) such as end user license agreements for software (EULAs) in this category of arms length non-coercive deal licenses because consumers are only entering into the agreement because they want to gain access to some form of proprietary software or technology to which they otherwise have no practical technological access.<sup>18</sup> Contrast this with activities they are doing with what they believe to be their own materials and technologies that then become the subject of policing efforts by another party alleging infringement of exclusive IP rights. I acknowledge that this may seem to be an imperfect or unsatisfactory distinction to some readers in that some software and other technology products are so pervasive as to seem "mandatory" to consumers and yet the EULAs or other retail IP license agreements may appear to be onerous "take it or leave it" contracts of adhesion.<sup>19</sup> Nonetheless, I reaffirm that these transactions are still more voluntary and discretionary than when one is approached by an IP owner with allegations of infringement for something that one is doing with one's own materials and technologies.<sup>20</sup> Fleshing out the deal license category a bit more are complicated joint venture or strategic alliance deals that contain IP licenses (and often cross licenses) as only one component of an overarching business relationship that may also entail stock swaps, collaborative research (perhaps generating still more IP), and perhaps even the creation of a new entity, co-owned by the joint venturers,

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ment proceedings and is thus still an effective, if somewhat weaker, club to be wielded by the patent troll.

18. See, e.g., Robert W. Gomulkiewicz, *Getting Serious About User Friendly Mass Market Licenses for Software*, 12 GEO. MASON L. REV. 687, 688-92 (2004).

19. See, e.g., Jean Braucher, *Amended Article 2 and the Decision to Trust the Courts: The Case Against Enforcing Delayed Mass-Market Terms, Especially for Software*, 2004 WIS. L. REV. 753 (2004).

20. See, e.g., Robert W. Gomulkiewicz & Mary L. Williamson, *A Brief Defense of Mass Market Software License Agreements*, 22 RUTGERS COMPUTER & TECH. L.J. 335 (1996).



to house the joint venture activities. The upshot is that few of these deal licenses should raise the same equitable concerns as those raised particularly by the abusive segment within the category of settlement licenses.

With this rough taxonomy of IP licenses in mind, we can delve back into what amount to two different threads of Supreme Court jurisprudence regarding the doctrine of licensee estoppel that form the critical background environment for *MedImmune*. Licensee estoppel is nicely summarized by the Court in a 1950 decision, *Automatic Radio Manufacturing Co. v. Hazeltine Research, Inc.*,<sup>21</sup> as “[t]he general rule. . . that the licensee under a patent license agreement may not challenge the validity of the licensed patent in a suit for royalties due under the contract.”<sup>22</sup> To some extent the two separate licensee estoppel case lineages track the vacillations of the Court over time between relatively pro-patent and anti-patent stances. Along the way, the Court grappled with the question whether limitations on the doctrine had so eroded it that it no longer existed.<sup>23</sup> However, at times the Court seemed to lose sight of the fact that a “general rule” is just that: it applies generally, but not always. Instead, the Court, in some instances, appeared to believe that if there were any limitations on the doctrine, then it must not be a viable doctrine anymore. Of course, legal doctrines often do not behave that way. Rather, arguably, there is a natural trajectory to them in which they are first articulated, then applied liberally until reaching some points where they begin to conflict with other doctrines or principles, and finally a time in which the boundaries of the appropriate application of the doctrine begin to take shape. In the following case law analysis, this theme will play out clearly. In the first section, we will follow the waxing and waning of licensee estoppel until its death in the 1969 case, *Lear, Inc. v. Adkins*.<sup>24</sup> If the first section chronicles the continued narrowing of the doctrine of licensee estoppel, then the second section documents the institution of limitations on *Lear*’s purported ban on licensee estoppel, essentially reviving the

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21. *Automatic Radio Mfg. Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950).

22. *Id.* at 836.

23. See *infra* Part II.A.

24. *Lear, Inc. v. Adkins*, 395 U.S. 653 (1969).

doctrine to some degree. Later, in Part III we will see how the Supreme Court waded into this alleged revival of licensee estoppel by the Federal Circuit when it handed down its unexpected opinion in *MedImmune*.

A. *Licensee Estoppel Before Lear v. Adkins*

Patents are hard to value because they have little intrinsic value. In the absence of a patent covering a good or service, everyone starts from the same legal position as to whether they can provide the good or service to the marketplace. If the good or service is not otherwise prohibited by law, then anyone can attempt to sell it in the marketplace. Thus, the patent does not give its owner the right *to provide* the covered good or service, rather it only gives her the right *to exclude* others from doing so. This is why the patent grant is often called a “negative right.”<sup>25</sup> The value of the patent to its owner, then, is to give her a competitive edge against others in the marketplace because she can legally enforce her right to be the only one providing the covered good or service there.

What is the value of this competitive edge that the patent’s exclusive or negative right gives to its owner? Arguably it is the (hopefully) increased profits that the patent owner is able to earn from sales of the covered good or service over acceptable market substitutes. The picture is more complicated, however, because there may be no acceptable market substitutes, in which case the patent owner may be able to effectively corner the market for what might turn out to be a new class of goods or services. In this case, the only alternatives to the consumer are to pay whatever price the patent owner demands or forego this type of good or service altogether. This latter scenario may be what people are thinking of when they refer to a patent as a government granted monopoly. In the opposite direction, a patent owner may find herself entering a marketplace with many acceptable market substitutes for her covered good or service. Further, some or all of these substitutes may have been patented by others, such that our patent owner can only provide her patented good or

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25. See, e.g., DONALD S. CHISUM ET AL., *PRINCIPLES OF PATENT LAW: CASES AND MATERIALS* 4-5 (3d ed. 2004) (introducing concept of exclusive right and reprinting Giles Rich’s famous formulation of it in lecture notes from Columbia Law School).

service in a competitive marketplace. Faced with the prospects of gaining only some minority market share, she may view the value of her patent as primarily a defensive measure to protect her market share, rather than as an offensive tool to give her pricing power. It will also work as a defense against the possibility that *someone else* might patent her good or service and force her out of the market entirely. In sum, the "value" of the patent to her can range from the high of a near monopolistic position to the low of mere survival.

Determining the value of a patent in a licensing situation requires different perspectives. Settlement licenses may be negotiated against a background record of established sales of infringing products, such that the licensor and licensee may have a sense of both the market value for products covered by the patent and the damage to the patent owner's own sales in that market.<sup>26</sup> Further, in cases where the infringer uses a costly production line tailored to produce an infringing good, the threat of an injunction that would shut this facility down may give some extra negotiating leverage to the patent owner. Nonetheless, the valuation of the license going forward can be complicated. What role does the patented technology really play in the infringing products, i.e. what percentage of the final product is covered by the patent? How might the market for the covered goods or services be changing and thus possibly affecting the potential revenue streams for the covered products? The situation is murkier for deal licenses. When parties contemplate an exclusive deal license for a yet to be commercialized product many factors must be considered. How close to market is the product as developed by the patent owner and covered by the patent? How much manufacturing R&D will the licensee have to undertake to actually bring a

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26. Of course, this interrelationship of sales of authorized products and infringing products can be complicated. For example, the existence of the infringing goods in the marketplace may have added enough supply to lower demand and hence price control for both the patent owner and the infringer, especially where the infringer was able to price its product substantially lower than the patent owner's version because the infringer avoided the R&D costs that the patent owner incurred in initially bringing the product to market. This has led to a proliferation of damages measures advanced by plaintiffs in infringement cases such as lost profits, etc. See generally ROBERT P. MERGES ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE* 347-49 (4th ed. 2006).

cost effective mass produced version of the patented product to market at a price point that prospective buyers will pay? What is this price point? How big is the total market for the class of goods and services that the patented product falls into? How much market share can the patent owner and its licensee expect the final marketed product to obtain? In essence, the patent owner/licensor in a commercialization deal license assumes two separate risks: first, the risk of bringing any product to market; and second, the risk that the licensee will inadequately execute a commercialization plan. At the end of the day, both settlement and deal licenses must be negotiated without any real certainty about the dollar value of the patent license to the licensee during the term of the license.

A standard solution to the expected value problem is the running royalty license. In this case, the parties negotiate a royalty rate – often somewhere between 1%-10% of net sales of the licensee's products embodying the patent – that the licensee will pay quarterly or annually based on actual sales recorded for the immediately preceding quarter or year.<sup>27</sup> This device ties the licensor's returns on the license to the actual use of the patent by the licensee and the success of the commercialization effort. Perhaps more importantly, it is in many cases the only viable mechanism that will allow the licensee to accept the license in the first place. For all but the largest or most cash-rich companies, it is not feasible to pay all of the net present value of the license (even if that could be calculated or simply stipulated as part of a negotiation) up front. Even a fixed or flat annual license fee – disconnected from any actual sales – could be a deal breaker for many licensees in that they would be obliged to pay the fee regardless of whether they made or sold any products under the license, or indeed were even in that line of business anymore. Essentially, flat fee arrangements run the risk of either seriously over- or under-compensating the licensor.<sup>28</sup> Regardless of the possible merits and

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27. See NGUYEN ET AL., *supra* note 8, at 113-17. Net sales are often used in lieu of gross sales because the licensee should not be paying a percentage of gross receipts that it takes in that may include payment for taxes assessed on the licensee or which may be effectively later reduced due to charge backs or other set offs.

28. The main use of flat fee arrangements seems to be in broad patent policing actions which may simply offer non-exclusive licenses to all identified potential infringers for a single or annual flat fee. Personally, these

uses of other license payment structures other than running royalty arrangements, this Article focuses on the latter because they constitute a substantial proportion of license agreements and are most affected by the *MedImmune* decision.

During the term of a running royalty license, the licensee may decide that its products or services are no longer covered by the patent (i.e., something about the product has been changed), or never should have been considered to have been covered by the patent. Alternatively, the licensee may decide that the patent should never have been issued in the first place, or that the patent owner/licensor is engaging in some activity such as patent misuse that renders the patent unenforceable until the activity ceases.<sup>29</sup> To clarify some of the nomenclature used in this section: (i) a patent that never should have been issued is “invalid”; (ii) a patent that is otherwise valid but whose enforcement may be blocked because of issues such as misuse is “unenforceable;” and (iii) a defendant’s activities that are outside the scope of the claims of an otherwise valid and enforceable patent are “noninfringing.” If any of these apply after the license agreement has been executed, the question arises as to whether and how the licensee can terminate its obligations – primarily as to payment – under the license. However, this might be framed as a simple freedom to contract issue whereby, absent any unconscionable clauses or duress in execution, the parties entered into their bargain and are estopped from challenging the contract when they later decide that the bargain was a bad one for them.

One obvious tactic for the licensee who believes that the license agreement should not apply to him anymore is for him to simply stop paying and repudiate the license. The licensor can then sue him on the basis of breach of contract and patent infringement theories (because the covenant not to sue component of the license is arguably no longer in force if the license has been repudiated and thus effectively terminated). The licensee is, of course, free to raise the affirmative defenses

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sorts of coarse grained licenses often strike me as more of a targeted industry-wide shakedown based on non-existent patents, patents of dubious validity, or relevance to the licensees’ activities. If the patents are strong and truly cover the alleged infringer’s activities, this arrangement would not make much sense.

29. See, e.g., NGUYEN ET AL., *supra* note 8, at 32-34.

that the license contract was invalid because of a failure of consideration. The basis of the bargain – a valid, enforceable, and infringed patent – turned out to be non-existent. This contract-based argument could be accompanied by an affirmative patent infringement defense that the underlying patent was invalid, unenforceable, or not infringed.

In fact, the foregoing strategy has been used by patent licensees going back to at least the late 1800s, as will be seen in the remainder of this section. A critical question raised early on in the litigation of these license disputes was whether a state or federal law theory of licensee estoppel would preclude (former) licensees from raising these kinds of challenges. In a case from 1905, *United States v. Harvey Steel Company*,<sup>30</sup> the Supreme Court appeared to find that a licensee – in this case the United States – was estopped from challenging the validity of a patent it had freely taken a license under before later repudiating the agreement.<sup>31</sup> The Court failed to state whether this licensee estoppel doctrine was of state or federal law origin. However, in 1942 the Supreme Court found in *Sola Electric Company v. Jefferson Electric Company*<sup>32</sup> that a patent validity challenge could be raised by a defendant as part of a *counterclaim* alleging federal antitrust law violations under the Sherman Antitrust Act<sup>33</sup> by the licensor/patent owner.<sup>34</sup> Thus, the Court was not treating the patent validity challenge raised by the licensee as an affirmative defense to either a contract breach or patent infringement claim, but rather as a separate counterclaim brought by the licensee against the licensor for anticompetitive actions in contravention of federal antitrust laws. The *Sola* Court acknowledged the *Harvey* Court's discussion of licensee estoppel doctrine, but asserted that the doctrine was not dispositive in the context of an antitrust violation counterclaim that required the Court to consider whether the successful enforcement of federal antitrust law and policy must lead federal courts to disregard conflicting state or local legal doctrines.<sup>35</sup> After finding that federal law and policy would indeed trump state or local law in this manner, the *Sola* Court

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30. *United States v. Harvey Steel Co.*, 196 U.S. 310 (1905).

31. *Id.* at 316-17.

32. *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173 (1942).

33. Sherman Antitrust Act of 1890, 15 U.S.C. §§ 1-7 (2000).

34. *Sola*, 317 U.S. at 177.

35. *Id.* at 174-77.

held that the licensee could challenge the validity of the patent, but only as part of the licensee's antitrust law counterclaim.<sup>36</sup> However, the *Sola* Court itself never clearly articulated why it believed that the licensee estoppel doctrine it was disregarding was a creature of state or local law, rather than federal law. Further, it left open the question as to whether, if a licensee estoppel doctrine could be found in federal law or policy (e.g., within the federal patent law), the law and policy behind the Sherman Antitrust Act would trump the law and policy behind that federal estoppel doctrine.

The following year the Supreme Court further bypassed the question of the validity of the doctrine of licensee estoppel in *Altwater v. Freeman*,<sup>37</sup> by finding that yet another patent validity challenge in the form of a counterclaim could be pursued. In this convoluted case, Freeman owned U.S. Patent No. 1,681,033 and granted licenses to Altwater and another party solely to produce dies covered by the patent, but not machines covered by the patent.<sup>38</sup> Altwater nonetheless marketed a machine arguably covered by the patent, in violation of the license agreement, and Freeman successfully sued him for specific performance of the agreement and was awarded an accounting for payment of royalties that would have been owed if Freeman had licensed Altwater to market the machines rather than just the dies.<sup>39</sup> Of note, the original license agreement apparently had a provision in which Altwater as licensee waived the right to challenge the validity of the patent during its life.<sup>40</sup> Regardless of this, the court in that proceeding appeared to have adopted the doctrine of licensee estoppel without reference to this contractual restriction.<sup>41</sup>

Around the same time, however, Freeman brought a separate litigation alleging infringement of his patent by an unlicensed company, Premier Machine Company.<sup>42</sup> The defendant successfully invalidated 23 of the 26 patent claims at issue

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36. *Id.* at 176-77.

37. *Altwater v. Freeman*, 319 U.S. 359, 364 (1943).

38. *Id.* at 360 n.1.

39. *Id.* at 360-61.

40. *Id.* at 360 n.1.

41. *Id.* at 361.

42. *Id.* (citing *Premier Mach. Co. v. Freeman*, 84 F.2d 425 (1st Cir. 1936)).

in the suit.<sup>43</sup> Freeman was then forced to issue disclaimers on the invalidated claims and surrendered his original patent to the U.S. Patent and Trademark Office (USPTO) for reissue with amended claims.<sup>44</sup> Meanwhile, Altvater apparently continued marketing infringing machines, while paying royalties as per the injunction order arising from the first suit. The royalties must have been inadequate from Freeman's perspective as he sued Altvater again for infringement and demanded specific performance of the original license agreement.<sup>45</sup> Nonetheless, the suit backfired on Freeman in that the District Court found that: (i) the machines did not infringe the reissued patents; (ii) the partial invalidation of the claims of the original patent in the Premier Machine Company litigation constituted an "eviction" of Freeman from his monopoly position of the patents under the terms of the Altvater license agreement; (iii) the Altvater license agreement terminated upon Freeman's surrender of the original patent in the reissue procedure with the USPTO; (iv) Altvater had not made the reissued patents the basis for a new license; (v) Altvater's continued payment of royalties was not acceptance of a new license or ratification that the old one continued in force, but rather performed only under protest and pursuant to the injunction from the earlier suit; and (vi) the reissued patents were invalid.<sup>46</sup> Some of these findings were based on allegations in counterclaims and a request for declaratory judgment by Altvater, while others were based on affirmative defenses.

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43. *Id.* (citing *Premier Mach. Co. v. Freeman*, 84 F.2d 425 (1st Cir. 1936)).

44. *Id.* at 361-62 (citing *Premier Mach. Co. v. Freeman*, 84 F.2d 425 (1st Cir. 1936)).

45. *Id.* at 362. The Court is simply not clear on exactly what triggered the second lawsuit that led to the instant appeal. It may be that the original injunction provided that Altvater pay royalties on the machines he had already sold in violation of the license agreement while ceasing to continue marketing such machines. His continued sale of machines afterwards may have been enough for Freeman to take him back to court for an order to discontinue such sales. However, one would presume that that would have taken the form of a request for the court to find Altvater in contempt if he were simply disregarding the original injunction. A more plausible story is that Altvater was marketing a different machine that Freeman believed also violated the now reissued patents. Two reissue patents – Nos. 20,202 and 20,203 – were issued in the place of the original partly invalidated patent. *Id.* at 360 n.1.

46. *Id.* at 362.



In addition, Altwater prayed that even if the reissued patents were found valid and his machines infringing, then the original license agreement would be extended to the machines at issue.<sup>47</sup> Ultimately, the District Court dismissed Freeman's bill of complaint and granted Altwater's prayer of counterclaim.<sup>48</sup>

The Court of Appeals for the Eighth Circuit affirmed the District Court's decision. But upon rehearing, the Eighth Circuit held that when the District Court found that the license had been terminated and there was no infringement under the reissued patents, all of the other issues in the counterclaim and request for declaratory judgment became moot.<sup>49</sup> On the rationale that there was no longer any justiciable controversy on the mooted issues, the Eighth Circuit modified the District Court's decree to remove the provisions holding that Freeman had been evicted from his monopoly by the decision in *Premier Machine Company*,<sup>50</sup> and that the reissued patents were invalid.<sup>51</sup>

Altwater appealed the modification of the decree to the Supreme Court which took the case to clarify an earlier holding in *Electrical Fittings Corporation v. Thomas & Betts Company*,<sup>52</sup> that it believed was being misinterpreted.<sup>53</sup> In that case, a District Court had held that a patent was valid but not infringed.<sup>54</sup> The infringement defendant appealed even though it had prevailed in its defense of no infringement because it was concerned that the trial court had found at least one of the claims of the patent to be valid.<sup>55</sup> The Court of Appeals for the Second Circuit dismissed the appeal because the petitioners "had been awarded all the relief to which they were entitled."<sup>56</sup> The Supreme Court took the case on certiorari and held that, despite the general rule that prevailing parties may not appeal findings that were unnecessary to support a ruling or decree, in the case where such findings are themselves *part* of the rul-

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47. *Id.*

48. *Id.*

49. *Id.*

50. *Premier Mach. Co. v. Freeman*, 84 F.2d 425 (1st Cir. 1936).

51. *Altwater*, 319 U.S. at 362-63.

52. *Elec. Fittings Corp. v. Thomas & Betts Co.*, 307 U.S. 241 (1939).

53. *Altwater*, 319 U.S. at 363.

54. *Elec. Fittings Co.*, 307 U.S. at 241-42.

55. *Id.* at 242.

56. *Id.*

ing or decree, the prevailing party may appeal to have those findings reversed or removed from a decree.<sup>57</sup> The *Altwater* Court seemed concerned that the Eighth Circuit misinterpreted *Electrical Fittings Corp.* to stand for the proposition that courts can never issue broad findings beyond whatever narrow holding is actually needed to decide the *plaintiff's* claims. The *Altwater* Court sought to clarify the prior holding by clearly stating that trial courts may, indeed must, adjudicate all of the live claims before them – *whether they arise from the original claims of the plaintiff or from any counterclaims filed by the defendant*. Thus, on the facts of *Altwater* itself, the infringement defendants had filed a number of counterclaims and the trial court was obliged to rule on all of them. This included, of course, those in the form of declaratory judgments. More importantly, it also included counterclaims such as the ruling of invalidity of the reissued patents that would have been moot and nonjusticiable if raised as affirmative defenses once the court found that there was no valid license agreement and that *Altwater's* machines did not infringe the reissued patents.<sup>58</sup>

*Altwater* also addressed the license estoppel doctrine, at least in passing. The Court restated the standard doctrine without necessarily committing to it.<sup>59</sup> However, the Court asserted that the doctrine was not implicated because the lower courts had already found that there was no license under the

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57. *Id.* Further, the reason that the finding of validity in the case was unnecessary was that the Supreme Court in both this case and in *Altwater* took pains to establish that while it is necessary for a patent infringement plaintiff to show that his patent is both valid *and* infringed, the infringement defendant need only show that *either* the patent was invalid or not infringed. See *Elec. Fittings Co.*, 307 U.S. at 242; *Altwater*, 319 U.S. at 363. In *Altwater* the Court cited with approval the Second Circuit's discussion in *Cover v. Schwartz*, 133 F.2d 541 (2d Cir. 1942), to the effect that federal courts actually stray outside of their Article III jurisdiction to hear only cases or controversies when they first reach a finding of non-infringement – which should dispose of the case – yet then continue on to adjudicate the validity of the patent: "To hold a patent valid if it is not infringed is to decide a hypothetical case." *Altwater*, 319 U.S. at 363.

58. *Altwater*, 319 U.S. at 363-64.

59. See *id.* at 364 ("It is said that so long as petitioners are paying royalties they are in no position to raise the issue of invalidity – the theory being that as licensees they are estopped to deny the validity of the patents and that so long as they continue to pay royalties, there is only an academic, not a real controversy, between the parties.").

reissued patents.<sup>60</sup> The Court then raised the critical issue of “coercion” that would echo all the way down to *MedImmune*, when it found that even though Altwater paid royalties under a license he believed to be invalid, he did so only on pain of violating the lower court’s injunction order *and* risking treble damages as a now willful infringer.<sup>61</sup> For emphasis, the Court cited the relatively new Declaratory Judgment Act, claiming that the law was passed “to afford relief against such peril and insecurity.”<sup>62</sup>

Another theme can be derived from *Altwater*, however, which is that a material change in circumstances can be the grounds for limiting the doctrine of licensee estoppel. The doctrine was always posited as a *general* rule, not as an absolute bar. It was an equitable rule to prevent licensees from trying to keep the benefits of a patent license while simultaneously trying to destroy the patent. However, as in most equitable doctrines, courts must use balancing tests to decide whether and how to apply licensee estoppel. For example, where a patent has been invalidated by other parties, a licensee should not have to keep paying royalties based solely on that patent. Thus, where a licensee stops paying royalties and is sued by the patent owner/licensor under such a scenario, surely the licensee must be able to raise the defense that the patent has in fact already been invalidated. Similarly, where other material changes are brought to light – perhaps fraud in the procurement of the license, or even of the patent itself from the USPTO – the licensee should be able to challenge the validity of the patent. The rationale for this is that if there were a failure of consideration or the basis of the bargain has been corrupted or frustrated, then the licensee can argue that it is not getting what it bargained for, or indeed that the contract should be held unenforceable or voided. Absent changed circumstances, the general principles of freedom to contract should apply and licensees should not be allowed to challenge the patent just because they no longer like the bargain they struck.

Wrapping up the early post World War II era’s support for the doctrine of licensee estoppel (and for strong patents and

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60. *Id.* at 364-65.

61. *Id.*

62. *Id.* at 365.

enforceable license agreements generally), the 1950 case of *Automatic Radio Manufacturing Co. v. Hazeltine Research, Inc.*<sup>63</sup> reiterated the “general rule. . . that the licensee under a patent license agreement may not challenge the validity of the licensed patent in a suit for royalties due under the contract.”<sup>64</sup> It also confirmed the antitrust or price-fixing exception to this general rule, citing<sup>65</sup> two cases that followed *Sola* in 1947 – *Edward Katzinger Co. v. Chicago Metallic Manufacturing Co.* and *MacGregor v. Westinghouse Electric & Manufacturing Co.*<sup>66</sup> *Hazeltine* likely represented the high point of licensor/patent owner favor by the Supreme Court. Justice Douglas wrote an impassioned dissent, joined by Justice Black, that foreshadowed the return of the public interest perspective in judicial review of patent and license arrangements in the 1960s.<sup>67</sup>

In sum, the cases through *Hazeltine* endorsed the doctrine of licensee estoppel,<sup>68</sup> but allowed it to be either disregarded or held inapplicable where there were materially changed circumstances or bad acts of the licensor. Additionally, there was no clear precedent that a licensee could bring a challenge to the patents as a *plaintiff* based on such changed circumstances. Rather, this narrow, developing exemption to the general doctrine of licensee estoppel seemed to exist only as a defense once the licensor had brought an infringement or specific performance action against the licensee. However, the 1960s would bring their social and political upheaval even into this

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63. *Automatic Radio Mfg. Co. v. Hazeltine Research, Inc.*, 339 U.S. 827 (1950). The case is often cited for one of its other important holdings – that there is no patent misuse when royalties are structured as a percentage of all sales by licensee regardless of whether the products sold embody the licenses patents. *Id.* at 834. As we will see, both holdings mentioned here have not fared well in the ensuing years.

64. *Id.* at 836.

65. *See id.*

66. *Edward Katzinger Co. v. Chicago Metallic Mfg. Co.*, 329 U.S. 394 (1947); *MacGregor v. Westinghouse Elec. & Mfg. Co.*, 329 U.S. 402 (1947).

67. *Automatic Radio*, 339 U.S. at 836-40 (Douglas, J., dissenting) (“Mr. Justice Brandeis and Chief Justice Stone. . . were alert to the danger that business – growing bigger and bigger each decade – would fasten its hold more tightly on the economy through the cheap spawning of patents and would use one monopoly to beget another through the leverage of key patents.”).

68. Without ever establishing whether it arises from federal, state, or local law.

technical corner of law represented by patents and licensing arrangements.

B. *The Death of Licensee Estoppel?: Lear v. Adkins*

By the 1960s, the Supreme Court was swinging towards greater concern over the interaction of state law doctrines in contract and unfair competition and the federal patent system. While the *Sola* Court had clearly articulated that federal anti-trust law and policy would trump state contract law doctrines such as licensee estoppel,<sup>69</sup> the latter was not held to be in conflict or superseded by federal patent law and policy (which might be perceived to seek to only enforce valid patents and encourage challenges to invalid ones). Thus, the exceptions to the "general rule" of licensee estoppel were fairly limited going into the 1960s.

In 1964, however, two companion cases were handed down by a Supreme Court that seemed to be newly invigorated to do battle against overreaching false monopolies whether arising from invalid patents, onerous license terms, or de facto patent-like monopolies enforced under state unfair competition laws. *Sears, Roebuck & Co. v. Stiffel Co.*<sup>70</sup> and *Compco Corp. v. Day-Brite Lighting, Inc.*<sup>71</sup> both involved uniquely shaped lighting fixtures which were originally the subject of a mechanical patent and a design patent, respectively, but both of which patents were invalidated pursuant to an affirmative defense of invalidity by the infringement defendants in the trial court in each case. However, in each case, the presumed patent owners had also brought state law unfair competition claims against the defendants because the defendants' products were essentially indistinguishable from the plaintiffs' products. The Court in each case overturned the unfair competition findings of the lower courts because the injunctions and accounting awards flowing from those findings impermissibly frustrated the balanced policy objectives of the federal copyright and patent systems between innovators and the public, noting in *Compco*: "Today we have held. . .that when an article is unprotected by a patent or copyright, state law may not forbid others to copy that article. To forbid copying would interfere with

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69. *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173, 177 (1942).

70. *Sears, Roebuck & Co. v. Stiffel Co.*, 376 U.S. 225 (1964).

71. *Compco Corp. v. Day-Brite Lighting, Inc.*, 376 U.S. 234 (1964).

the federal policy, found in Art. I, § 8, cl. 8, of the Constitution and in the implementing federal statutes, of allowing free access to copy whatever the federal patent and copyright laws leave in the public domain.”<sup>72</sup> In essence, the Supreme Court was showing great interest in reviving and enforcing a robust public domain.

Then, in 1969, the other shoe dropped. While *Sears and Compco* did not involve license agreements, and thus had no specific impact on licensing, the Supreme Court rewrote its history as to interpreting the doctrine of licensee estoppel and overruled *Hazeltine* in *Lear, Inc. v. Adkins*.<sup>73</sup> Reaching back to a set of cases from the 1800s that were seemingly hostile to licensee estoppel and predated the cycle of estoppel friendly cases starting with *Harvey* in 1905 (where our story started above), the *Lear* Court argued that a better balance between the rights of patent owners/licensors and the public interest needed to be struck.

The case was based around an odd fact pattern in which the Lear aviation company hired an engineer, Adkins, specifically to create a better gyroscope, yet expressly allowed him to keep ownership to any patentable inventions arising from his work.<sup>74</sup> Lear and Adkins entered into an agreement that Adkins would grant Lear a license to all he ideas he might develop “‘on a mutually satisfactory royalty basis.’”<sup>75</sup> Adkins later filed a patent application and the parties entered into a more definitive license agreement, conditioned on the ultimate issuance of the patent or any subsequent finding of invalidity.<sup>76</sup> However, Adkins’ application got caught up in the usual back

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72. *Id.* at 237.

73. *Lear, Inc. v. Adkins*, 395 U.S. 653, 671 (1969).

74. *Id.* at 655-57. Today, unless the engineer was such a superstar that he could negotiate to retain ownership of his inventions made on the company’s time and as part of his job, engineers like Adkins would sign an invention assignment agreement giving all right and title to such inventions to the employer. Further, although it was not clearly addressed in the Court’s opinion, it is odd that Lear did not attempt to rely on the common law “hired to invent” exception to the standard “shop rights” doctrine that would have granted ownership of Adkin’s invention to Lear as a matter of common law. Of course, an express allocation of ownership of the invention to Adkins by Lear officials, as it sounds like may have happened, would override this common law allocation. *See id.* at 657.

75. *Id.* at 657.

76. *Id.*

and forth with the examiners at the USPTO and did not issue until six years after he filed it.<sup>77</sup> During this time, the company became convinced that the patent would never issue and declared that they would cease royalty payments, which they did shortly thereafter.<sup>78</sup> In 1960, Adkins' patent finally issued and he sued Lear for the royalties owed per the license agreement. The company sought to defend itself at least in part by challenging the validity of the patent, which was rejected by the trial court on the basis of licensee estoppel.<sup>79</sup> Upon a complicated set of cross appeals, the California Supreme Court ultimately concluded that the license agreement was valid and that Lear was estopped from challenging the patent as an affirmative defense.<sup>80</sup>

The case was then appealed to the U.S Supreme Court. The Court's new interest in the public domain was highlighted in its description of the issue available for its review: "[T]he only issue open to us is raised by the court's reliance upon the doctrine of estoppel to bar Lear from proving that Adkins' ideas were dedicated to the common welfare by federal law."<sup>81</sup> From that starting point, the *Lear* Court undertook a somewhat revisionist view of its own history in interpreting the licensee estoppel doctrine. It acknowledged that a very early case, *Kinsman v. Parkhurst*,<sup>82</sup> adopted a licensee/assignee doctrine of estoppel,<sup>83</sup> but pointed out that a later 1891 case, *St. Paul Plow Works v. Starling*,<sup>84</sup> "did not even question the right of the lower courts to admit the licensee's evidence showing that the patented device was not novel."<sup>85</sup> Further, in a footnote to its citation of *Kinsman*, the *Lear* Court cited two other early cases predating *St. Paul Plow Works* – *Eureka Co. v. Bailey Co.*<sup>86</sup> and *Dale Tile Manufacturing Co. v. Hyatt*<sup>87</sup> – as "cases

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77. *Id.* at 658

78. *Id.* at 659-60.

79. *Id.* at 660.

80. *Id.* at 660-61.

81. *Id.* at 662.

82. *Kinsman v. Parkhurst*, 59 U.S. 289 (1855).

83. *Id.* (where the licensee/assignee had already profited greatly from sales of the covered machine, the Court queried why a new finding of invalidity of the underlying patent would affect the assignee's profits already collected.)

84. *St. Paul Plow Works v. Starling*, 140 U.S. 184 (1891).

85. *Lear*, 395 U.S. at 663.

86. *Eureka Co. v. Bailey Co.*, 78 U.S. 488 (1870).

87. *Id.*

which enforced patent licenses without a thorough consideration of the estoppel issues that were presented.”<sup>88</sup> Finally, it rolled out a case that “found the doctrine of patent estoppel so inequitable that it refused to grant an injunction to enforce a licensee’s promise never to contest the validity of the underlying patent.”<sup>89</sup> That case, *Pope Manufacturing Co. v. Gormully*,<sup>90</sup> was then quoted approvingly for its public interest perspective: “‘It is as important to the public that competition should not be repressed by worthless patents, as that the patentee of a really valuable invention should be protected in his monopoly.’”<sup>91</sup>

These early cases require a brief analysis to place them into better context however. First, *Kinsman* is a bit different than a straightforward licensee estoppel case. The agreement at issue was not a license agreement at all, but rather a kind of partnership agreement between a patent owner and his partial assignee.<sup>92</sup> The partners were primarily allocating their responsibilities to jointly bring patented ginning machines to market.<sup>93</sup> Their agreement mentioned nothing about a license, because, of course, there was no license as the partners were now co-owners of the patent at issue.<sup>94</sup> There was evidence of bad faith by the assignee/partner/co-venturer (*Kinsman*) together with a third party (*Goddard*) and ultimately the patent owner/partner/co-venturer (*Parkhurst*) brought an action against *Kinsman* and *Goddard* to recover monies owed to him under the agreement and to allege other violations of the partnership agreement which now constitute patent infringement.<sup>95</sup> The lower court ruled against *Kinsman* and *Goddard* and ordered an accounting on the basis of monies owed to *Parkhurst* from sales already completed. The defendants then appealed to the Supreme Court. The *Kinsman* Court reported the principle basis of the appeal as that “*Parkhurst* was not the

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87. *Dale Tile Mfg. Co. v. Hyatt*, 125 U.S. 46 (1888).

88. *Lear*, 395 U.S. at 663 n.11.

89. *Id.* at 663.

90. *Pope Mfg. Co. v. Gormully*, 144 U.S. 224 (1892).

91. *Lear*, 395 U.S. at 663-64 (quoting *Pope*, 144 U.S. at 234).

92. *Kinsman v. Parkhurst*, 59 U.S. 289, 290-92 (1855).

93. *Id.*

94. *Id.*

95. *Id.* at 292.



original and first inventor of the thing patented.”<sup>96</sup> Whether this was meant as a novelty challenge to the patent or a fraud allegation was unclear. But that was of no moment because the Court found that the invalidity of the patent was essentially irrelevant to the issue of an accounting for sales already completed.<sup>97</sup> Most important, even as the Court then proceeded to raise an estoppel against the defendants for using invalidity as a defense, this was simply not the same as the estoppel involved in licensee estoppel cases:

Moreover, we think the defendants are estopped from alleging that invalidity. They have made and sold these machines under the complainant’s title and for his account; and they can no more be allowed to deny that title and retain the profits to their own use, than an agent, who has collected a debt for his principal, can insist on keeping the money, upon an allegation that the debt was not justly due.<sup>98</sup>

The *Lear* Court did not call *Kinsman* a licensee estoppel case per se, but it included it as part of its discussion of the doctrine of licensee estoppel and did not make clear the very different nature of the parties’ relationship in *Kinsman* from that of licensor-licensee. The Court further marginalized *Kinsman* by stating that it “was decided before the Sherman Act made it clear that the grant of monopoly power to a patent owner constituted a limited exception to the general federal policy favoring free competition.”<sup>99</sup> This is true, but it is hard to see what bearing federal antitrust law would have had on the facts and outcome of *Kinsman* even if it had been in place at the time. In fact, *Kinsman* is arguably even more help to supporters of licensee estoppel than the *Lear* Court may have realized. In raising the agency analogy, the *Kinsman* Court both introduced the idea that assignees and licensees may be a kind of agent to the assignor’s or licensor’s principal, as applicable, and thus may not keep that which it has received in charge for its principal regardless of whether the transactions

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96. *Id.*

97. *Id.* at 292-93 (“Having actually received profits from sales of the patented machine, which profits the defendants do not show have been or are in any way liable to be affected by the invalidity of the patent, its validity is immaterial.”).

98. *Id.* at 293.

99. *Lear, Inc. v. Adkins*, 395 U.S. 653, 663 (1969).

with third parties are legal.<sup>100</sup> Essentially, the *Kinsman* Court seemed concerned about allowing a windfall or unjust enrichment to Kinsman (and Goddard by extension). This seems a correct way to think about licensees who have already collected payments on goods sold under what they now want to claim is an invalid patent. In many cases, the very prices they charged to the end user may have been inflated based on the existence of what even the licensee may have been representing as a valid patent. To allow the licensee to have realized the benefit of the patent's pricing power and then try to withhold the agreed to royalties on the already received revenues based on a defense that the patent was actually invalid during the sales period, would amount to an impermissible windfall or unjust enrichment to the licensee at the licensor's expense. This says little, of course, about the equities of a situation where the licensee wants to challenge the patent to avoid paying royalties on *future* sales.

The next case in chronological order, *Eureka*, did not "seriously consider" the estoppel doctrine simply because there was no clear challenge to the patent and so the Supreme Court did not review the issue. The estoppel type language that arose was not licensee estoppel in the sense of a defense of patent invalidity, but a different kind of licensee estoppel that arises in later cases where the challenge is to whether licensee's products in fact would infringe the patent but for the license. *Eureka* also involved reissued patents, which appear repeatedly as a problem in license disputes and constitute one of my "changed circumstances" that can trigger a valid dispute for an existing licensee and limit estoppel claims. The *Eureka* Court was nonetheless highly skeptical of the licensee's defense that its products did not infringe the reissued patent, especially since the licensee had presented the licensor with samples of the actual machine and both parties agreed that it was covered by the license.<sup>101</sup> Further, it did not use the term "estoppel" but merely stated that "we are not at all satisfied that, in equity, [defendant] can be permitted to set up this

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100. See *Kinsman*, 59 U.S. at 293. The Court then cited cases where agents who received monies or property in entirely illegal transactions were still not allowed to use the illegality of the activities as a defense against their principals who sought an accounting. *Id.*

101. *Eureka Co. v. Bailey Co.*, 78 U.S. 490, 491-92 (1870).

defense, while it makes no attempt by cross-bill, or even in the answer, to show that the agreements were obtained by fraud, surprise, or imposition."<sup>102</sup> Essentially, the Court was looking for some kind of changed circumstance, or even new knowledge (such as that the agreement was obtained by a fraud), before allowing the licensee to now argue that its machines did not infringe the patent at issue. The defendant did allege some fraud in its defense but it was an alleged fraud by the patent owner on the USPTO to reissue the earlier patent with new or different claims that should not have been allowed. The Court asserted that such fraud allegations against the USPTO could not have been raised in the instant proceeding but would have to have been raised in "a direct suit to impeach and set aside the patent."<sup>103</sup> This might be an early version of a kind of licensee estoppel to challenge the enforceability of a patent, and possibly the validity of it, but whatever it was, it was a clear bar for the Court not merely a "very strong presumption" standard as the *Lear* Court seemed to describe it.<sup>104</sup> Finally, the *Eureka* Court made it crystal clear that there simply was no serious attempt by the defendant to challenge the patent as to novelty (and hence validity): "Some attempt is made to assail the novelty of Allender's invention, but as no notice was given of any such attempt, or of the witnesses or other evidence by which that charge was to be supported, it cannot be considered in this case."<sup>105</sup> Thus, I would not interpret this

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102. *Id.* at 492.

103. *Id.* (citing *Rubber Co. v. Goodyear*, 76 U.S. 788(1869)).

104. *Lear*, 395 U.S. at 663 n.11. The "strong presumption" language actually appeared in the *Eureka* Court's speculation about the defendant's *intent* or *motivation* in attempting to argue that its machines were not covered by the reissued patent:

After making the agreement in this case, an agreement made on due deliberation, the defendant being engaged in the business of making the machines before it took the license, an agreement manifestly intended to adjust conflicting rights, and after furnishing one of the machines as a sample of what it proposed to do under that agreement, and after having made and sold five hundred of them, there arises a very strong presumption that the denial that anything in those machines is covered by plaintiff's patent is made to support an unwillingness to pay the royalty which it had agreed to pay.

*Eureka*, 78 U.S. at 491-92.

105. *Eureka*, 78 U.S. at 492.

as any statement by the Court as to whether it accepted or rejected licensee estoppel as a general rule, but rather that it declined to consider the entire question of the defendant raising a novelty/validity challenge to the patent as it was inadequately presented.<sup>106</sup>

The other case that *Lear* cited for lack of thorough consideration of estoppel issues “presented” was *Dale Tile Manufacturing Co. v. Hyatt*.<sup>107</sup> Like *Lear*’s characterization of *Eureka*, it seems odd to say that the *Dale Tile* Court did not give “thorough consideration” of licensee estoppel issues, as if that Court were expressing some reservation or uncertainty about the doctrine or how to apply it. That is simply not the case. The *Lear* Court did correctly state that the *Dale Tile* Court affirmed the decision of a New York state court to invoke licensee estoppel, but then continued on to say that this was because “the estoppel question presented was one which involved only state law.”<sup>108</sup> This mischaracterizes the *Dale Tile* Court’s position. It was not as though that Court considered there to be a different estoppel doctrine for federal versus state law, and was thus only affirming a state law version. Rather, the *Dale Tile* Court appeared to believe that licensee estoppel – at least at the time it was deciding the case – was *always* a state law issue because *patent licenses were always state law matters*.<sup>109</sup> In other words, disputes over patent licenses simply did not arise under federal patent law, but rather only under state contract law.<sup>110</sup> Thus, a federal doctrine of licensee estoppel was impossible since there was no federal law governing patent license agreements,<sup>111</sup> and disputes over such

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106. Additionally, the *Eureka* Court seemed comfortable applying estoppel type principles to clearly presented issues. In essence, it seemed to have viewed all of the defendant’s attempts to raise affirmative defenses to the plaintiff’s charges of failure to pay and infringement as just so many evasive maneuvers of a party that was not willing to pay its fair and legally binding obligations. The Court was happy to bar these on estoppel type theories.

107. *Dale Tile Mfg. Co. v. Hyatt*, 125 U.S. 46 (1888).

108. *Lear*, 395 U.S. at 663 n.11.

109. *Dale Tile*, 125 U.S. at 52.

110. *Id.* (“[I]t is clearly established, by a series of decision of this court, that an action upon [a patent license] as that here sued on is not a case arising under the patent laws.”).

111. *Id.* at 53 (quoting *Wilson v. Sandford*, 51 U.S. 99, 101-02 (1850) (“[T]he dispute in this case does not arise under any act of congress; nor does the decision depend upon the construction of any law in relation to

agreements did not arise under the federal patent (or other) laws.

In the penultimate case of the *Lear* Court's review of 19th century estoppel precedents – *St. Paul Plow Works* – the *Lear* Court alleged that the case was “often cited as supporting the estoppel doctrine [but] points clearly in the opposite direction” because it “did not even question the right of the lower courts to admit the licensee's evidence showing that the patented device was not novel.”<sup>112</sup> This is facially wrong. The problem was that the estoppel issue was simply not raised by either party on appeal to the Supreme Court. Estoppel was raised in the lower court by the plaintiff when the defendant put evidence in to challenge plaintiff's patent, but the objection was overruled and the evidence as to novelty admitted.<sup>113</sup> Yet, in the opinion from the lower court, the judge seemed to contradict this: “I have hesitated about going into the question of novelty, but, there being in the contract of license no recital or admission that plaintiff had invented the improvement in sulky plows, and the plaintiff having joined issue on the defense of want of novelty set up in the answer, *and not pleaded an estoppel*, I have reluctantly allowed the defendant to introduce evidence on that issue, and find that the plaintiff's improvement is not anticipated by any of the patents introduced in evidence.”<sup>114</sup> While I am no expert on pleading rules in the 1890s, I can hazard a guess that the plaintiff failed to formally raise an estoppel claim in response to the defendant's challenge to plaintiff's patent in the defendant's original answer to plaintiff's claims. Thus, even the trial court was precluded from allowing the plaintiff to raise the estoppel claim during the course of the trial when the evidence challenging novelty was actually introduced into evidence by the defendant. Further, the trial court ruled for plaintiff on the patent validity question anyway, and so the plaintiff did not appeal the ruling. While the defendant certainly did appeal a number of the rulings of the lower court, including the court's finding that the

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patents. It arises out of the contract stated in the bill; and there is no act of congress providing for or regulating contracts of this kind. The rights of the parties depend altogether upon common-law and equity principles.”)).

112. *Lear*, 395 U.S. at 663.

113. *St. Paul Plow-Works v. Starling*, 140 U.S. 184, 189 (1891).

114. *Id.* at 190 (quoting *Starling v. St. Paul Plow-Works*, 29 F. 790, 792 (C.C. Minn. 1887)) (emphasis added).

plaintiff's patent was valid, the defendant was certainly not going to question the lower court's rejection of the *plaintiff's* estoppel argument as improperly plead (presumably). At any rate, the Supreme Court declined to review the validity finding because it believed that the finding was a question of fact properly left to the lower court and not a matter of law for review.<sup>115</sup> Even if the Supreme Court had reviewed the finding of validity, it would not be proper for it to somehow interject an estoppel to reject defendant's challenge to the patent. The estoppel claim was the responsibility of the plaintiff to raise; if he failed to properly do so, and given that the lower court's ruling in this regard was *not* appealed by the plaintiff to the Supreme Court, then it would be bizarre for the Supreme Court to add this claim in at the appeal level of its own accord.

This brings us to *Pope*, the case cited by the *Lear* Court as finding "the doctrine of patent estoppel so inequitable that it refused to grant an injunction."<sup>116</sup> Again, this is facially wrong. The *Pope* Court was not at all addressing the doctrine of licensee estoppel such as a plaintiff might use it to bar a defendant's challenge to a patent in a legal proceeding. Rather the Court was rejecting a version of a "no contest" contractual clause in which a licensee agrees to not contest the licensed patents no matter what. Thus, the Court, sitting in equity not law, refused to require specific performance of the defendant based on what it viewed as an unconscionable contract and license, perhaps even procured under misrepresentation, that precluded him from disputing or contesting the validity of the underlying patents: "The real question is whether the defendant can estop himself from disputing patents which may be wholly void, or to which the plaintiff may have no shadow of title."<sup>117</sup> This was a legitimate question, because the contract at issue has essentially moved licensee estoppel from an equitable doctrine that can be invoked by plaintiffs in the right circumstances to a contractual obligation on the part of the defendant. As I argue throughout this Article, estoppel should always have been justified in each case where it was raised by a plaintiff; it should never have been interpreted as an absolute automatic bar or bright line rule. The other prob-

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115. *St. Paul*, 140 U.S. at 196-97.

116. *Lear*, 395 U.S. at 663.

117. *Pope Mfg. Co. v. Gormully*, 144 U.S. 224, 233 (1892).

lem with the contract language at issue in *Pope* was that it seemed to restrict even the standard limitations on licensee obligations where the underlying patent had been invalidated by other parties. Essentially, the *Pope* Court was highly concerned that the defendant/licensee had unwittingly stripped himself of all legal rights to defend himself against even the most specious of claims that the plaintiff/licensor might come up with: "It is as important to the public that competition should not be repressed by worthless patents, as that the patentee of a really valuable invention should be protected in his monopoly; and it is a serious question whether public policy permits a man to barter away beforehand his right to defend against unjust actions or classes of actions, though, in an individual case, he may doubtless assent that a judgment be rendered against him, even without notice."<sup>118</sup> Finally, the context of the case included evidence in the record that Gormully, the licensee, might have been bamboozled by Pope Manufacturing Company into signing the contract without fully understanding that he was literally signing away his rights.<sup>119</sup>

Having set up an alternative universe of precedents that it sometimes misconstrued to oppose the doctrine of licensee estoppel, the *Lear* Court then dismissed the *Harvey* and *Hazeltine* cases as if they were aberrations.<sup>120</sup> Further, the Court asserted that the *Hazeltine* Court "ignored the teachings of a series of decisions this Court had rendered during the 45 years since *Harvey* had been decided."<sup>121</sup> Essentially, the *Lear* Court exaggerated the reasonable limitations and parameters that courts were placing around an otherwise unfettered licensee estoppel doctrine – "each time a patentee sought to rely upon his estoppel privilege. . .[we] created a new exception"<sup>122</sup> – until it could claim that "the estoppel doctrine had been so

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118. *Id.* at 234. Note that the *Lear* Court cited only the first part of this important quote, and seemed to spin it out of context to sound like a rant against patents generally. See *Lear*, 395 U.S. at 693-94.

119. *Pope*, 144 U.S. at 237 ("The testimony. . . was fully reviewed by the court below in its opinion, and the conclusion reached that the contract 'was an artfully contrived snare to bind the defendant in a manner which he did not comprehend at the time he became a party to it.'" (quoting *Pope Mfg. Co. v. Gormully*, 34 F. 877, 883-84 (C.C. Ill. 1888))).

120. See *Lear*, 395 U.S. at 664.

121. *Id.*

122. *Id.*

eroded that it could no longer be considered the 'general rule,' but was only to be invoked in an ever-narrowing set of circumstances."<sup>123</sup> But, the Court appeared to ignore the nature of "general rules": they are general because they *generally apply*, but not necessarily in every specific situation.

To further buttress its claims for a "seriously eroded" estoppel doctrine, the *Lear* Court tossed a few more cases, this time from the early 20th century, onto the fire. *Westinghouse Electric & Manufacturing Company v. Formica Insulation Company*<sup>124</sup> was supposed to limit the estoppel doctrine by allowing an assignor of a patent, who now wanted to challenge the patent, to introduce prior art to narrow a claim in the patent (although *not* to invalidate the patent).<sup>125</sup> The *Lear* Court ran a bit roughshod over this case too. The *Formica* Court did a nice nuanced job of working through *assignor* estoppel issues and came up with a sensible set of guidelines. As a preliminary matter, it is critical to note the different equities at play as between *assignor* estoppel and *licensee* estoppel. In the former, an inventor or patent owner has transferred title to the patent to another party. The *Formica* Court aptly analogized this to an assignment of title to land.<sup>126</sup> Surely, the patent assignor cannot deny that valid title was conveyed to the underlying patent anymore than a selling land owner can later deny that valid title was conveyed to the property covered by the transferred deed. If they could, then equally surely must the assignee in both cases be able to demand all payment back from the assignor for the thing purportedly conveyed (but now denied). Contrast this with a license situation where the licensee is not at all in control of, or representing anything about, the patent being licensed. To reiterate a discussion above, the clearest equitable issue to ground *licensee* estoppel is instead that the licensee is a kind of agent to the licensor's principal and cannot have profited from the benefit of that agency (having rights to market a product that are not freely available to everyone else) and then deny such agency when the time for payment of royalties for the agency "right" comes nigh. Thus, at

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123. *Id.*

124. *Westinghouse Elec. & Mfg. Co. v. Formica Insulation Co.*, 266 U.S. 342 (1924).

125. *Lear*, 395 U.S. at 664-65.

126. *Formica*, 266 U.S. at 349-50.



one level, *assignor* estoppel cases have little bearing on *licensee* estoppel cases, despite the *Lear* Court's efforts to gloss over this point.<sup>127</sup>

However, the *Formica* Court agreed that the assignor should not be estopped from every crazy interpretation of the scope of the patent claims that the assignee might bring as against the assignor for infringement of the assigned patent.<sup>128</sup> In other words, just because the assignor is estopped from denying the overall validity of the patent (akin to a seller of land later denying that he conveyed valid title), he should not be constrained in what he believes to be legitimate non-infringing activities just because the assignee claims that the scope of the assigned patents reaches to these activities. Thus, assignors are not estopped from bringing evidence that goes to the *scope* of the claims, to raise the defense that assignor's products do not actually infringe the patent. Assignors are estopped, however, from bringing evidence for a defense that the assigned patent is invalid. Justice Taft, writing for the Court, acknowledged that "[t]he distinction may be a nice one but seems to be workable."<sup>129</sup> Certainly, one can foresee that assignors will be tempted to interpret the scope of the claims effectively out of existence, but this will simply be a matter that courts would have to be vigilant about. At the same time, there is a bright line rule to this: as a formal matter, the assignor cannot articulate its defense as one based on the *invalidity* of the patent, but rather only as one based on the *non-infringement* of his products. This again raises the crucial difference between assignors and licensees in estoppel matters. While a licensee may be seen, based on the circumstances, to have been presented with

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127. Note that some exclusive licenses may be the functional equivalent of an assignment, and thus some licenses may be seen as assignments. This blurring does not change my analysis here, for the point is simply to distinguish situations where the party who procured the patent in the first place, and then assigned or exclusively licensed it to someone else, now wants to deny the validity of the patent so as to practice the covered invention with impunity (despite having assigned or licensed away this very right), from situations where a licensee who had nothing to do with procuring the patent nonetheless negotiates a license to the patent with appropriate due diligence and sophistication, and then later wants to challenge the validity of the patent simply because he now realizes the license was a bad bargain for him.

128. See *Formica*, 266 U.S. at 350-51.

129. *Id.* at 351.

a patent and then made a voluntary decision that its products might infringe the claims of that patent (and thus warrant taking a license), an assignor has only committed itself to having sold good title in a valid patent and, perhaps, some representations about the scope of the patent's claims. This then set up the *Formica* Court's further delimitation of the doctrine of assignor estoppel peculiar to the facts of the case before it. The assignee had assigned a patent *application*, not an issued patent. The Court worried that if even an issued patent's claims are harder to know the scope of than, say, land that has been duly surveyed, then it will be that much harder for the assignor to know the scope of the yet-to-be-issued patent arising from his assigned application.<sup>130</sup> In particular, because the scope of the claims may ultimately be either curtailed or enlarged through the patent procurement process with the USPTO,<sup>131</sup> the Court believed that an inventor who assigned his application before the issuance of the patent, and then had little to no role in the procurement process, may have genuine questions about the scope of the final issued patent with regard to his products. Accordingly, he should not be estopped from challenging the scope of the final issued patent, other than as to the scope of claims that he clearly intended to convey and assign to the assignee.<sup>132</sup>

The *Lear* Court raised a second assignor estoppel case – *Scott Paper Co. v. Marcalus Manufacturing Co.*<sup>133</sup> – to continue

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130. *Id.* at 352-53.

131. Although today any enlargement of the patent application's scope after filing will lose the applicant the benefit of the initial filing date for invention priority purposes against other inventors who claim to have invented first.

132. Although, even here, if any conveyed claims are rejected by the USPTO and not issued as part of the final patent, then the assignor is not estopped from defending against infringement by bringing evidence that his product cannot infringe unissued or rejected claims. See *Formica*, 266 U.S. at 354-55. The *Formica* Court spent little time on the interesting issue of whether assignor estoppel should even apply in this case as the alleged infringer of the patent, *Formica*, is a corporation in which O'Connor, the original inventor and assignor of the patent (when he worked at Westinghouse), was only one shareholder among others. See *id.* at 355. One can see an inventor/assignor trying to "hide" behind a corporation to avoid assignor estoppel, but on the other hand, one can also see the equitable limitations on allowing an inventor/assignor to "taint" every venture and entity that he might happen to become associated with in the future.

133. *Scott Paper Co. v. Marcalus Mfg. Co.*, 326 U.S. 249 (1945).

nudging along its argument that licensee estoppel had been eroded out of existence. In this case, the reasonably foreseeable abuse of the *Formica* rule that assignors would simply become more aggressive in attacking the scope of their assigned patent's claims to effectively read them out of existence, was put to the test. Mr. Marcalus invented a purportedly new box making machine while employed by Scott Paper Co., and then left that company after the patent issued and he had assigned it to Scott Paper.<sup>134</sup> He set up a competing box manufacturer, Marcalus Manufacturing, and used a machine that Scott Paper believed infringed the very patent he had assigned to them.<sup>135</sup> In defense to Scott Paper's infringement suit, Marcalus Manufacturing claimed that its new machine did not infringe the assigned patent and offered evidence of an expired patent that was claimed to be the basis for the new machine.<sup>136</sup> The expired patent had not been considered as part of the prior art when the assigned patent was being procured from the USPTO and arguably would have destroyed the assigned patent's novelty, preventing its issuance.<sup>137</sup> The trial court found this to be a way for Mr. Marcalus to achieve by "indirection" that which he would not have been able to achieve directly because of assignor estoppel.<sup>138</sup> The Circuit Court of Appeals for the Third Circuit reversed, finding the effective destruction of the assigned patent, through permissible "narrowing" of its claims by Marcalus Manufacturing to show non-infringement, was just an unfortunate by-product of the proper limitation on assignor estoppel.<sup>139</sup> The Supreme Court took the case on certiorari and found that it could decide the case without disturbing or commenting on the scope of the *Formica* rule.<sup>140</sup> In particular, "unlike *Formica*, the accused machine is precisely that of an expired patent. Neither in that case nor in

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134. *Id.* at 250-51.

135. *Id.* at 251.

136. *Id.*

137. *Id.*

138. *Id.*

139. *See id.*

140. *Id.* at 254 ("But in the circumstances of this case we find it unnecessary . . . to determine whether. . . the doctrine of estoppel by patent assignment as stated by the *Formica* case should be rejected. To whatever extent that doctrine may be deemed to have survived the *Formica* decision or to be restricted by it, we think that case is not controlling here.").

any other, so far as we are advised, was the doctrine of estoppel applied so as to penalize the use of the invention of an expired patent.”<sup>141</sup>

To dig a little deeper into the parties’ arguments as summarized by the Court, it appears that Mr. Marcalus’ patent was novel as to an improvement on the expired patent, although his issued patent may have seemed to encompass the claims of the prior, but unknown at the time, patent.<sup>142</sup> Marcalus Manufacturing, as defendant to the infringement suit, agreed to estoppel as to claims that the *improvements* were invalid (or for that matter that the entire patent was invalid), but not as to defenses showing that the new machine did not infringe the assigned patent, as it was limited by the scope and claims of the expired patent, and thus did not extend to the improvements that may be the novel heart of his assigned patent.<sup>143</sup> In this way, Marcalus Manufacturing was not questioning the *Formica* rule, nor arguing that it did not apply to the case, but merely showing how the rule should be applied.

Returning to the equitable basis of assignment estoppel, as agreed to even by Justice Frankfurter in his spirited dissent in the case,<sup>144</sup> patent assignors, like other conveyers of title, should not be allowed to sell assignees an empty bill of goods. In other words, whatever it is they purport to sell and convey for value to the assignee, they cannot then later claim that it is invalid or non-existent. That principle was upheld in *Formica* and untouched in *Marcalus*. Exactly what was purported to be conveyed from Mr. Marcalus to Scott Paper was not clear from the case, although it sounded as if Mr. Marcalus and Scott Paper were both unaware of the expired prior art patent and may have believed that Mr. Marcalus was conveying title to a patent that covered all of the machine he developed while working for Scott Paper. *Formica* provided that assignors are not estopped from challenging claims that are ultimately rejected by the USPTO even though the assignor intended to assign those claims as part of an unissued patent application. But that was not the case in *Marcalus*. Instead, it seemed that both Mr. Marcalus and Scott Paper engaged in the original

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141. *Id.*

142. *Id.* at 253-54.

143. *Id.*

144. *See id.* at 258-64 (Frankfurter, J., dissenting).

procurement and assignment of the patent in good faith, but that, unbeknownst to them at that time, the patent would ultimately have very little value because of the later discovered prior art patent. As a matter of infringement analysis, Marcalus Manufacturing cannot be found to have infringed the subject matter of an expired patent that was now part of the public domain – whose free use is a vital part of the public policy goals of the patent system. Thus, Marcalus Manufacturing must have been allowed to defend its new machine on the basis of noninfringement, even as it was estopped – by virtue of Mr. Marcalus's role as the original assignor of the patent – from denying the validity of what was sold to the assignee.

The *Lear* Court then turned to an analysis of *Sola's* anti-trust based limitation of licensee estoppel, while also invoking the “even more extensive scope” of the “‘anti-trust exception’”<sup>145</sup> as found in *Katzinger* and *MacGregor*. There is no doubt that the “antitrust exception” had found a permanent place in the licensee estoppel doctrine by this time. And yet, this exception, together with some other limited exceptions or clarifications around the doctrine such as the rejection of the no-contest clause in the license agreement at issue in *Pope*, failed to extinguish the doctrine of licensee estoppel, erode it into meaninglessness, or eliminate the basic equitable principles at its core. What the *Lear* Court saw as a fatal chipping away at the doctrine through all of the cases developing since the 19th century, I see as only the normal developing, maturing, and proper cabining of any legal doctrine. A legal principle or rule is first articulated, and then it is applied in ever expanding fashion until it reaches some boundaries wherein it is clear that its own equitable powers of persuasion have attenuated enough that the equitable powers of another doctrine that it has come in conflict with override the first doctrine's power *at that point in “jurisprudential space.”* It is at that point or line that the first doctrine has now had a boundary established for it. Over time this boundary may shift as the equitable sense of courts and the people change, but in many cases the heart of the doctrine is not extinguished and there remains the paradigmatic cases that define it. It should not be viewed as a death knell when the initial boundaries are discovered or even

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145. *Lear, Inc. v. Adkins*, 395 U.S. 653, 666-67 (1969).

changed over time, so long as the paradigmatic heart remains compelling for the people and the courts.

The *Lear* Court, armed with only its revisionist history of licensee estoppel cases (including assignor estoppel cases added in to bolster the sense of inevitability to its doctrinal erosion theory), then proceeded to overrule *Hazeltine*.<sup>146</sup> At the same time, it set up an entirely new rule for licensee estoppel based on little more than speculation about how parties enter into patent licenses,<sup>147</sup> a smattering of law review articles and uncited cases presumably cited within those articles,<sup>148</sup> and a clear bias against patents and their owners.<sup>149</sup> Essentially, the Court framed this as a conflict between state contract law and federal patent law,<sup>150</sup> which indeed it was. The real problems in the opinion occurred when the Court took it upon itself to speculate, in one telling paragraph, about the “most typical” license situations:

It will simplify matters greatly if we first consider the most typical situation in which patent licenses are negotiated. In contrast to the present case, most manufacturers obtain a license after a patent has issued. Since the Patent Office makes an inventor's ideas public when it issues its grant of a limited monopoly, a potential licensee has access to the inventor's ideas even if he does not enter into an agreement with the patent owner. Consequently, a manufacturer *gains only two benefits* if he chooses to enter a licensing agreement after the patent has issued. First, by accepting a license and paying royalties for a time, the licensee may have avoided the necessity of defending an expensive infringement action during the period when he may be least able to afford one. Second, the existence of an unchallenged patent may deter others from attempting to compete with the licensee.<sup>151</sup>

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146. *Id.* at 671.

147. *See id.* at 669-70.

148. *See id.* at 667, 668 n.13.

149. *See id.* at 669-71.

150. *See id.* at 668.

151. *Id.* at 669 (emphasis added).

The problem with the Court's assessment in the first "benefit" is that it appears to only consider one side of the quid pro quo of the "patent bargain" – the foundational principle that society grants inventors a period of exclusivity to profit off their inventions in exchange for the inventor's enabling disclosure of that invention and its transmission to the public domain, free for all to use, after the exclusive period ends. In the quoted paragraph above, the Court seems to view patent exclusivity as a nuisance to be avoided by any means possible. Yet, this ignores the fundamental premise for the patent bargain: inventors may well try to keep their inventions secret, and profit off them for an unlimited period as trade secrets to the detriment of society, in the absence of a compelling incentive to disclose them. If courts nip away at the value of this incentive to inventors, or encourage others, including licensees, to game the system to diminish the value of the incentive to inventors, then inventors may well begin deciding that the benefits of the patent system are not enough and that it is better to try and work their inventions in secret indefinitely.

The Court's second "benefit" is at least more on the mark, and actually supports my argument that the equities of the license situation at least demand that the licensee live up to its end of the license agreement for the benefits it has already received under the license and patent at the time it decides to repudiate or dishonor the agreement. However, the *Lear* Court spun this in a negative way by discussing the benefit of only an "unchallenged" patent, as if patents only deter others when they have not yet been challenged. Clearly a patent validated in a court proceeding should be dramatically even more of a deterrent. Why is this not even mentioned? My suspicion is that the Court looked askance at most patents and belied in this passage that it thought most of them would be invalidated if challenged.

The Court's negativity as to patents and their owners was further substantiated when the Court turned to a discussion of the equities involved when a patent owner/licensor seeks a court's assistance in enforcing his license. Rather than leading with presumably the majority of cases where the patent has been obtained legitimately and the license fairly entered into, the Court instead began with the example of "the licensor who has obtained his patent through a fraud on the Patent Of-

fice.”<sup>152</sup> The Court then attacked licensee estoppel by arguing that “It is difficult to perceive why good faith requires that courts should permit him to recover royalties despite his licensee’s attempts to show that the patent is invalid.”<sup>153</sup> But this is a bit of a straw man – who actually believes that courts should enable these kinds of shenanigans? Further, from my analysis of the entire set of licensee estoppel cases above, I think that this kind of claim – fraud on the USPTO – could be brought by the licensee without estoppel under two theories. First, under a pure contract law analysis the licensee would not be estopped from bringing evidence that the entire basis of the bargain – the patent – was in fact a fraud. Now, if the licensee was perfectly aware of the evidence that the patent was procured in fraud and still took the license, then perhaps estoppel should still apply. This goes back to my suggestion that the key test for when estoppel should be limited is when something new has happened or come to light during the course of the license. If there are no new facts or changed circumstances from the time when the licensee entered into an arms length license with reasonable diligence, other than the fact that he no longer wishes to pay royalties or feels that ultimately it was a bad bargain and he wants to repudiate it, why should he be able to defend the eventual infringement and breach of contract suit by now attacking the patent itself? Further, as also discussed above, if he has benefited from the exclusivity of the patent generally – certainly if he was an exclusive licensee, but even if he was a non-exclusive licensee – he must not be able to renege on paying royalties on money he received from customers based on this exclusive or semi-exclusive position in the marketplace.

Even when the Court turned to consider, as a secondary matter, the “more typical cases, not involving *conscious* wrongdoing” it made the equities out to be almost entirely on the put-upon licensee’s side.<sup>154</sup> After explaining what it deemed the *ex parte* nature of patent procurement with the USPTO and the presumption of validity afforded patents, the Court

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152. *Id.* at 669.

153. *Id.* at 669-70.

154. *Id.* at 670 (emphasis added). At least the Court acknowledged that most patent are not procured based on fraud. But rather than leaving it at that, it had to qualify “wrongdoing” with “conscious” as if most patents are based on at least an unconscious wrongdoing.



suggested that this already stacked the deck in favor of patentees.<sup>155</sup> Thus, it concluded that "it does not seem to us to be unfair to require a patentee to defend the Patent Office's judgment when his licensee places the question in issue. . ."<sup>156</sup>

As a preliminary matter, I generally support the calls for more post-grant patent opposition opportunities for members of the public who object to a patent that has issued. I also think that a general ability for members of the public to submit possible prior art to the USPTO when it considers a particular patent application is a good thing. However, when all is said and done, and a patent has issued, any member of the public who believes that their products or process infringe the claims of the patent, but who also believes that the patent is invalid, should continue as they are and defend an infringement suit if one materializes. It is true that some firms or individuals will feel that a reasonably low licensing fee or royalty rate is preferable to the wild card of patent litigation costs and potential damage awards. And this leads to what I have called industry "shake down" licenses. But equally prevalent is the "pay now or pay later" attitude that weighs whether a certain payment now is better or worse than a potential payment later.<sup>157</sup> Absent a finding of willfulness, a losing patent infringement defendant will generally only have to pay whatever a reasonable royalty would have been, plus perhaps interest and other charges to make the patent owner whole (as if the defendant had in fact entered into the license). Therefore, one could equally say that licensees have an obligation of due diligence to make sure that they really believe that the patent is valid and that their products or processes will infringe it. If that is the case, and no material circumstances change or new facts come to light later, then it seems to me that the licensee should live with his bargain like any other party to a contract.

Before finally turning to its disposition of the facts of the case at hand, the *Lear* Court gave one more argument in favor of dismantling the licensee estoppel doctrine that has contin-

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155. *See id.*

156. *Id.*

157. The calculus involved in this decision can be complex and is heavily reliant on three key variables: i) the strength of the patent (i.e., how likely is it to be upheld or validated in court); ii) the likelihood that the potential licensee's products or processes will be found to infringe (valid) claims of the patent; and iii) the potential licensee's tolerance for risk.

ued on through the debates over not just estoppel, but also those culminating in *MedImmune* regarding the ability of licensees to bring declaratory judgment actions with essentially no triggering event to try to invalidate the patent underlying the license. To wit: "Licensees may often be the only individuals with enough economic incentive to challenge the patentability of an inventor's discovery."<sup>158</sup> This perspective may be true in some cases. However, it may be equally true in others that licensees – especially exclusive licensees – are the *last* individuals or organizations to have an incentive to challenge the patent, else they lose their exclusive position in the marketplace when the patent owner/licensor loses his patent.<sup>159</sup> So, the licensee "watchdog" of the public interest might just choose to muzzle himself.

Of course, the Court ultimately had to deal with the extra complication that Adkins had licensed his unpatented invention to Lear even before an application was filed with the USPTO. Thus, there were three time periods at issue for the Court to consider whether royalties were owed by Lear. First, the period before the patent issued. Second the patent term itself. Third, and perhaps crossing over the other two, the period during the pendency of the infringement trial itself. The Court ruled on the third period by speculating that if licensees were required to keep paying royalties during a suit over the license, then licensors would have incentive to "devise every conceivable dilatory tactic."<sup>160</sup> Perhaps so, but whichever way a rule like this goes, someone will have an opportunity to game the system. To the second question, and as the holding that *Lear* is most known for, the Court found that "Lear must be permitted to avoid the payment of all royalties accruing after Adkins' 1960 patent issued if Lear can prove patent invalidity."<sup>161</sup> The holding as it appears is not in the form that it is generally stated in the literature afterwards. Interestingly, the latter form appeared in *Lear* earlier in the Court's analysis as it

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158. *Lear*, 395 U.S. at 670. The Court then continued its general patent and patent owner bashing with the colorful tag: "If [licensees] are muzzled, the public may continually be required to pay tribute to would-be monopolists without need or justification." *Id.*

159. See, e.g., Rochelle Cooper Dreyfuss, *Dethroning Lear: Licensee Estoppel and the Incentive to Innovate*, 72 VA. L. REV. 677, 698-700 (1986).

160. *Lear*, 395 U.S. at 673.

161. *Id.* at 674.

considered what other courts were doing: "Some courts have gone further to hold that a licensee may notify the patent owner that he is repudiating his agreement, regardless of its terms, and may subsequently defend any action for royalties by proving patent invalidity."<sup>162</sup> This "repudiate then invalidate" approach has become a critical aspect of *Lear's* legacy (before *MedImmune*). Yet, nothing about *Lear's* clear formulation of its own holding requires this, other than perhaps because the case involved a repudiating licensee and holdings arguably should be limited to the specific facts of the case as a jurisprudential matter. In theory, then, *Lear* may not have completely eliminated licensee estoppel, although it certainly appeared to have tried. It could be that neither the parties nor the *Lear* Court expected licensees to bring declaratory judgment actions to challenge an underlying patent even while continuing as licensees in good standing, as later happened in *MedImmune*. Finally, as to the first period for potential royalty payments by *Lear* – the pre-patent issuance period – the Court punted the question back to the California state courts in part because it was a matter of state law (to the extent that state law protection of unpatented ideas is not pre-empted by the federal patent law system) and partly because the California Supreme Court did not rule on the issue as it had thought licensee estoppel applied to any attempt by *Lear* to challenge either the patent or its earlier incarnation as a kind of trade secret.<sup>163</sup>

Much of this Article has now been dedicated to cases leading up to and including *Lear*. This is not by accident or poor design, but rather because *Lear* "settled" the doctrine of licensee estoppel essentially from when it was handed down in 1969 until this year's *MedImmune* decision. Despite its apparent attempts to do so, however, it did not also eliminate assignor estoppel.<sup>164</sup> Before turning to *MedImmune*, we must briefly review a handful of cases in the Court of Appeals for the Federal Circuit that distinguished themselves from *Lear* in ways that arguably kept a form of licensee estoppel alive, at least as to non-repudiating licensees or licensees in good standing in the intervening years.

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162. *Id.* at 667.

163. *Id.* at 674-75.

164. *See, e.g.,* *Diamond Scientific Co. v. Ambico, Inc.*, 848 F.2d 1220 (Fed. Cir. 1988).

### C. *Lear's Aftermath in the Federal Circuit*

In 1988's *Hemstreet v. Spiegel, Inc.*,<sup>165</sup> the Federal Circuit declined to extend *Lear* to allow a party to a settlement order approved by a federal court as settlement of a patent dispute to later attempt to renege on its payments under the order on the basis of the invalidation of the underlying patents by a third party. The Federal Circuit invoked the public policy interests of encouraging patent litigation settlements as well as the doctrine of res judicata. Three years later, in *Foster v. Hallco Manufacturing Co., Inc.*,<sup>166</sup> the Federal Circuit overturned a district court ruling that a party to a consent decree, which settled a patent dispute by finding the patents valid and enforceable, could nonetheless challenge those patents in a declaratory judgment action. In particular, the district court, whether aware of the Federal Circuit's decision in *Hemstreet* or not, nonetheless essentially ignored that court's ruling on res judicata and instead relied on the general public interest policies articulated in *Lear* to allow the declaratory judgment challenge. The Federal Circuit then held that *Lear* did not abrogate res judicata, that there were additional public policy issues involved in settlement situations (as it had discussed in *Hemstreet*), and that it alone could interpret *Lear* for the district courts (except of course where the Supreme Court might further rule in the area).

In 1997, the Federal Circuit ventured a little further in critiquing *Lear* in *Studiengesellschaft Kohle, M.B.H. v. Shell Oil Company*.<sup>167</sup> The court reiterated earlier rulings in the Supreme Court that licenses are primarily treated under state contract law, rather than federal patent law.<sup>168</sup> It then noted the *Lear* Court's skepticism to intellectual property,<sup>169</sup> before it asserted that *Lear* "requires this court to consider 'whether overriding federal policies would be significantly frustrated' by enforcing [a] license."<sup>170</sup> Based on this interpretation of its duties under *Lear*, the Federal Circuit found that it could de-

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165. *Hemstreet v. Spiegel, Inc.*, 851 F.2d 348 (Fed. Cir. 1988).

166. *Foster v. Hallco Mfg. Co.*, 947 F.2d 469 (Fed. Cir. 1991).

167. *Studiengesellschaft, M.B.H. v. Shell Oil Co.*, 112 F.3d 1561 (Fed. Cir. 1997).

168. *See id.* at 1567.

169. *Id.*

170. *Id.* (quoting *Lear, Inc. v. Adkins*, 395 U.S. 653, 670 (1969)).

tect “no significant frustration of federal patent policy by enforcing the 1987 license agreement [between the parties] to the extent of allowing [the licensor] to recover royalties until the date [licensee] first challenged the validity of the claims.”<sup>171</sup> In particular, the court then arguably revived a version of licensee estoppel by considering the actual equities involved with a decidedly less anti-IP eye than the *Lear* Court: “this court must prevent the injustice of allowing Shell to exploit the protection of the contract and patent rights and then later to abandon conveniently its obligations under those same rights.”<sup>172</sup> Ultimately, the Federal Circuit held that a “licensee. . . cannot invoke the protection of the *Lear* doctrine until it (i) actually ceases payment of royalties, and (ii) provides notice to the licensor that the reason for ceasing payment of royalties is because it has deemed the relevant claims to be invalid.”<sup>173</sup>

In the opening years of the 2000s, the Federal Circuit decided two final cases in its sequence of interpretations of *Lear* before *MedImmune* reset the stage once again. In *Flex-Foot, Inc. v. CRP, Inc.*,<sup>174</sup> the Federal Circuit expanded its rulings on the public policy importance of upholding the doctrine of res judicata in the context of enforcement of settlement agreements which contain license agreements and no-contest clauses. Specifically, the court added that contract estoppel, in addition to res judicata principles, barred a party to a license from challenging a patent that had been litigated over between the same two parties three times, and from which a valid settlement agreement had been obtained that contained representations that the patents were valid.<sup>175</sup>

Finally, in *Gen-Probe Incorporated v. Vysis, Inc.*,<sup>176</sup> the Federal Circuit drew a line barring licensees in good standing from bringing a challenge to the underlying patent as essentially a freestanding legal action under the Declaratory Judg-

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171. *Id.* at 1568.

172. *Id.*

173. *Id.* (citing numerous circuit courts that had reached the same conclusion).

174. *Flex-Foot, Inc. v. CRP, Inc.*, 238 F.3d 1362 (Fed. Cir. 2001).

175. *See id.* at 1370.

176. *Gen-Probe Inc. v. Vysis, Inc.*, 359 F.3d 1376 (Fed. Cir. 2004).

ment Act.<sup>177</sup> As a case study in the tendency of parties to push and game the system in the wake of any new rule, the *Gen-Probe* dispute revolved around a potential patent infringer, Gen-Probe, that took *Lear* to its logical and clearly intended conclusion and attempted to have it both ways: a covenant not to sue from the patentee *and* control as plaintiff of a direct challenge on the patents. As baldly summarized by Gen-Probe itself, the tactic was indeed a brilliant move based on a reasonable interpretation of the *Lear* Court's overzealous attempt to rid the law once and for all of licensee estoppel:

"This letter concerns the June 22, 1999 agreement between Vysis and Gen-Probe concerning the Collins Patents. Since the date of that agreement, we have analyzed the Collins Patents. Based upon that analysis, we have concluded that the claims of the Collins Patents are invalid. Furthermore, we don't believe that any product made, used or sold by Gen-Probe, either individually or in conjunction with others, infringes any claims [sic] of the patents that might ultimately be determined to be valid.

Based on our prior dealings and conversations, we understand that Vysis disputes those positions. Therefore, concurrently with the delivery to you of this letter, Gen-Probe is filing an action in the United States District Court seeking relief concerning the Collins Patents.

In order to preserve the status quo pending resolution of the litigation, Gen-Probe and Chiron Corp. have exercised the options [sic]. . .to extend the license to Gen-Probe and Chiron Corp. for purposes of their blood screening business. For the same reason, Gen-Probe and Bayer Corp. have exercised the option. . . to extend the license to Gen-Probe and Bayer Corp. for purposes of their infectious disease testing business.

Gen-Probe has participated in the exercise of the foregoing options not because we believe the patents are valid, but solely in order to preserve the status quo pending resolution of the litigation. Based on present circumstances, Gen-Probe and its allied parties expect to fulfill their obligations under the licenses during the pendency of the litigation."<sup>178</sup>

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177. *Id.* at 1380 (interpreting Declaratory Judgment Act, 28 U.S.C. § 2201(a) (2000)).

178. *Id.* at 1378-79.

Talk about crazy-making legal tactics to tweak your opponent! I actually started laughing out loud while retyping this letter, as reproduced in the *Gen-Probe* opinion, as the sheer brazenness of it – couched in eminently reasonable sounding language of course – fully set in.

First off, while it was true that the license at issue was always more of a settlement license – as I define such in my taxonomy above – than a deal license, nonetheless there was nothing legally coercive about the execution of the license. Vysis and Gen-Probe had been involved in litigation regarding other patents when Vysis was awarded U.S. Patent No. 5,750,338 (the ‘338 Patent) for a wholly unrelated technology. Vysis used well developed drafting and communications strategies to avoid triggering a declaratory judgment action by Gen-Probe. To wit, rather than sending a cease and desist letter asserting infringement and demanding either a cessation of Gen-Probe’s activities or the execution of a license agreement, Vysis’ President and CEO used the following language in a letter to his counterpart at Gen-Probe: “Our interest continues to be to obtain resolution of all of the existing intellectual property issues at one time. . . . To that end, I would like to bring to your attention some additional, recently issued patent assets under our control which we believe Gen-Probe should find of interest.”<sup>179</sup> After some back and forth which the Federal Circuit acknowledges could have caused Gen-Probe to “detect[ ] a significant likelihood that it would be sued for infringement”, Gen-Probe took a license to the ‘338 Patent and two other related patents (collectively, the Collins Patents).<sup>180</sup> This license appears to have been duly negotiated, in all likelihood with competent counsel assisting on both sides, given the nature of the parties, and seemed to be relatively sophisticated. It provided for a \$1.5M up-front payment and a running royalty of 3% on Gen-Probe’s sales of licensed products.<sup>181</sup> Further, it granted Gen-Probe a six month option to extend the terms and coverage of the license to its third party allies in the DNA assay market.<sup>182</sup> In sum, Gen-Probe knew exactly what it was getting into and took the time to carefully

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179. *Id.* at 1377.

180. *Id.* at 1377-78.

181. *Id.* at 1378.

182. *Id.*

negotiate and execute a reasonable patent license. Should it not have been expected to analyze the Collins Patents *before* entering into this license? If it had doubts about the patents and whether its products would infringe those patents, it should have undertaken further diligence, before deciding to take the license or roll the dice in a possible infringement suit. Fully understanding that Gen-Probe (and other parties) may have taken the license as a pragmatic decision in the face of the uncertainty provided by a patent infringement suit, I assert that all of this nonetheless is simply the basis of the bargain for the license as a contract. If Gen-Probe later became unhappy with the deal, and provided that nothing happened to change the circumstances (other than presumably Gen-Probe's delinquent diligence that was fully within its control), it should have had no recourse other than to continue performing under the license or to repudiate or breach it and then challenge the patents in either an infringement suit brought by Vysis or a declaratory judgment action brought by itself.

The second amazing part of Gen-Probe's letter was that it was dated the *last day its options under the license remained valid* and provided notice that it was *exercising* those options *even as it gave further notice that it was going to file a declaratory judgment action the very next day to try to destroy the underlying patents*. The coup de grace of course, was the letter's insistence that all of this was being done merely to "preserve the status quo" pending the outcome of litigation *it was initiating against the licensor*. Finally, although the letter did not directly express this fact, competent counsel reading the letter would instantly have understood that Gen-Probe's language regarding its intention to fulfill all of its obligations under the license was likely really meant to signal to Vysis that the latter would have to sit back and let Gen-Probe take the reins in litigation over the patents via the declaratory judgment action, as Vysis would have no grounds to bring its own patent infringement or breach of contract suit against Gen-Probe.

This kind of gaming was untenable to the Federal Circuit which overturned the district court's ruling that it could hear the case and that the patents were invalid and not infringed. The Federal Circuit held that neither the district court nor itself had subject matter jurisdiction over the declaratory judg-



ment action as there was no “actual controversy.”<sup>183</sup> The court recited a number of different tests articulated by itself and the Supreme Court to determine whether an “actual controversy” existed. Overall, it settled on its own precedents, as informed by Supreme Court cases on the matter, that decisions must be made on the totality of the circumstances with the following as guidelines:

There must be both (1) an explicit threat or other action by the patentee, which creates a reasonable apprehension on the part of the declaratory judgment plaintiff that it will face an infringement suit, and (2) present activity which could constitute infringement or concrete steps taken with the intent to conduct such activity.<sup>184</sup>

The question remained after *Gen-Probe* whether the Federal Circuit’s willingness to block licensee challenges to patents based on doctrines such as *res judicata*, collateral estoppel, and, now, absence of a justiciable case or controversy, were really just smoke screens for that court’s desire to reinstate licensee estoppel in total or in part. I am concerned that the focus frequently seems to be whether a doctrine is strong enough to be applied in essentially a bright line fashion, and, if not, then perhaps it should be chunked into the dustbins of history. Instead, I think that what are essentially equitable doctrines such as licensee estoppel must be applied in the extraordinary, discretionary way that cases in equity should always be treated, *i.e.*, look to the specific equities of the parties and decide what will be most just in that case.<sup>185</sup> Regardless, we will now turn to the *MedImmune* decision as the Supreme Court’s now definitive pronouncement of this whole area of law.

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183. *Id.* at 1379-82 (citing 28 U.S.C. § 2201(a) for the requirement of “actual controversy”).

184. *Id.* at 1379-80 (quoting *BP Chems. Ltd. v. Union Carbide Corp.*, 4 F.3d 975, 978 (Fed. Cir. 1993)). See also *EMC Corp. v. Norand Corp.*, 89 F.3d 807 (Fed. Cir. 1996); *BP Chems. Ltd. v. Union Carbide Corp.*, 4 F.3d 975 (Fed. Cir. 1993); *Spectronics Corp. v. H.B. Fuller Co.*, 940 F.2d 631 (Fed. Cir. 1991).

185. In *Ebay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837 (2006), the Supreme Court held that rather than grant an injunction as almost a matter of right for patent owners who succeeded in showing infringement, courts must apply a four-factor test to weigh the equities – including that of the public interest – before deciding to grant such an injunction.

## III.

BURNING DOWN THE HOUSE: THE ASYMMETRY OF LITIGATION  
OPTIONS AFTER MEDIMMUNEA. *The MedImmune Decision*

Genentech and City of Hope co-owned U.S. Patent No. 4,816,567 (Cabilly I), directed to the use of cell cultures to manufacture human antibodies.<sup>186</sup> The application for Cabilly I was filed on April 8, 1983 and led to both that patent and a continuation application filing on June 10, 1988 that would ultimately issue as U.S. Patent No. 6,331,415 (Cabilly II).<sup>187</sup> However, long before the latter issued, it was the subject of an interference proceeding<sup>188</sup> with U.S. Patent No. 4,816,397 (Boss), owned by Celltech R & D, Ltd., with a British priority date of March 25, 1983.<sup>189</sup> Seven and a half years later, the Board of Patent Appeals and Interferences (BPAI) decided priority in favor of Boss (and ultimately then Celltech).<sup>190</sup> Genentech then brought a civil action in district court to challenge or overturn the BPAI's ruling.<sup>191</sup> Based on the complexity of the issues and technology, the district court urged Genentech and Celltech to mediate the dispute, which they did.<sup>192</sup> A retired judge acted as mediator and the parties entered into a settlement agreement in which both parties agreed that the Cabilly II application had priority as against Boss, based on new evidence involving a draft patent application.<sup>193</sup> "Genentech and Celltech also entered into a cross-li-

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186. *MedImmune, Inc. v. Genentech, Inc.*, 427 F.3d 958, 961 (Fed Cir. 2005). The ownership is referred to as by assignment on the part of both Genentech and City of Hope likely because the patent arose from collaborative research between Genentech and City of Hope and was assigned by the inventors/employees/researchers of one or both entities to the public-private partnership. See *MedImmune, Inc. v. Genentech, Inc.*, 127 S. Ct. 764, 767-68 (2007).

187. *MedImmune*, 427 F.3d at 961.

188. Interference proceedings are declared by the USPTO to determine priority of invention, and hence which, if either, of two patents or applications is valid. See 35 U.S.C. § 135 (2000) (establishing rules for interference proceedings in USPTO).

189. *MedImmune*, 427 F.3d at 961.

190. *Id.* (citing *Cabilly v. Boss*, 55 U.S.P.Q.2d 1238 (Bd. Pat. App. & Int. 1988)).

191. *Id.*

192. *Id.* at 962.

193. *Id.*

cense agreement that included a formula for sharing royalties."<sup>194</sup> The district court accepted the parties' settlement, entered judgment as to the priority of the Cabilly II application, and ordered the USPTO to vacate its decision, revoke Boss, and issue a patent on the Cabilly II application.<sup>195</sup> After some further delay and issues through no fault of Genentech, Cabilly II was finally issued by the USPTO on December 18, 2001.

In the meantime, MedImmune, Inc. had taken a license in 1997 from Genentech for what must have been the family of patents that issued or might issue from the original Cabilly I application, thus including Cabilly II once it issued.<sup>196</sup> Apparently hedging its bets, MedImmune had also taken a license to Boss from Celltech in 1998. MedImmune, Inc. manufactures Synagis, a drug used to prevent respiratory tract disease in infants and young children.<sup>197</sup> After the issuance of Cabilly II, Genentech notified MedImmune that Synagis was covered by the claims of the newly issued patent, and thus subject to royalties under the 1997 license agreement, to begin in March 2002.<sup>198</sup> MedImmune objected, believing that Cabilly II was invalid and unenforceable, and that in any event Synagis did not infringe the patent's claims.<sup>199</sup> Similar to Gen-Probe's actions in *Gen-Probe*, MedImmune decided to both pay the royalties to avoid an infringement suit from Genentech and to bring a declaratory judgment action to challenge Cabilly II.<sup>200</sup> The district court granted Genentech's motion to dismiss on the grounds of lack of subject matter jurisdiction in light of the Federal Circuit's decision in *Gen-Probe*.<sup>201</sup> MedImmune ap-

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194. *Id.*

195. *Id.* (citing *Genentech, Inc. v. Celltech R & D, Ltd.*, No. 3:98cv03929 (N.D. Cal. March 16, 2001)).

196. *Id.*

197. *MedImmune, Inc. v. Genentech, Inc.*, 127 S. Ct. 764, 767 (2007).

198. *Id.* at 768. Assumedly, neither Cabilly I nor any patent arising from its application other than Cabilly II actually covered Synagis, and MedImmune had not heretofore been paying any royalties on sales of the product to Genentech. It is unclear from both the Federal Circuit and Supreme Court opinions whether MedImmune had any other products covered by Cabilly I or other patents in its family, such as Cabilly II.

199. *Id.*; *MedImmune*, 427 F.3d at 962.

200. *MedImmune*, 127 S. Ct. at 768; *MedImmune*, 427 F.3d at 962.

201. *MedImmune, Inc. v. Genentech, Inc.*, CV 03-2567 (C.D. Cal. Apr. 26, 2004). See *MedImmune*, 127 S. Ct. 776-77; *MedImmune*, 427 F.3d at 961-62.

pealed the decision to the Federal Circuit which, unsurprisingly, affirmed it against MedImmune's argument that *Gen-Probe* improperly resurrected the doctrine of licensee estoppel abolished by *Lear*.<sup>202</sup>

MedImmune further appealed and the Supreme Court granted certiorari. The majority opinion, written by Justice Scalia, asserted that the Court was considering both a free-standing claim of patent invalidity and a contract dispute over whether the patent was invalid or non-infringed and hence whether royalties were owed under the license agreement.<sup>203</sup> In dissent, Justice Thomas disagreed by asserting that the Court should only consider the freestanding claim of invalidity and not reach the contract claim.<sup>204</sup> The majority believed that this distinction likely did not affect the issue of subject matter jurisdiction at any rate.<sup>205</sup> However, this may have been too much of a gloss: live contract disputes have been paradigmatic examples of "actual controversies" under the Declaratory Judgment Act since soon after it was passed; patent validity questions have not. Accordingly, once this "threshold" issue has been decided, it may well have decided the case.

Nonetheless, it is interesting to see yet another formulation of the debate over whether a license dispute is at essence a matter of patent law or contract law, or whether that perhaps depends on exactly what is being disputed: the validity of a patent in and of itself; the existence of a valid contract; or the interpretation of what is considered by the parties to be a valid contract. To put a point on it though, this debate, which seems to take on almost metaphysical or scholastic dimensions at times, brings two contrasting intuitions into play. From the first perspective, one might say that licenses which have a variation of the standard clause "royalties are to be paid until such time as the patent is held invalid or unenforceable" mean that a licensee can frame a contract dispute over whether the underlying patent is currently valid and enforceable. From the second perspective, one can say that patent validity and enforceability are patent law questions that have nothing to do with interpreting *contract terms* but rather *patent terms and*

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202. *MedImmune*, 427 F.3d at 961.

203. *MedImmune*, 127 S. Ct. at 768-70.

204. *Id.* at 769; *id.* at 777-80 (Thomas, J., dissenting).

205. *Id.* at 777.

*claims.* The contract interpretation perspective might argue that even if this is true, a finding of patent invalidity or unenforceability goes to the basis of the license contract bargain and thus becomes a contract dispute again. Yet, few license agreements that I am aware of represent or warrant the validity or enforceability of the patent; rather at most they only represent that the licensor is the owner of the issued patent, or has rights under it, and has no reason to believe that it is invalid or unenforceable.<sup>206</sup> This would be especially true in licenses that grant rights to patent applications, continuations, reissues, etc. as was the case in the Genentech-MedImmune license. Where a patent has not even yet issued, ipso facto the owner of the application cannot represent or warrant its validity or enforceability. Thus, the basis of the license bargain is the covenant not to sue made by the patent (application) owner, in exchange for payment by the licensee. This payment, however, is often measured in terms of royalties tied to sales of licensed products. Therefore, whether a product of the licensee is a "licensed product," i.e., covered by the claims of the licensed patents, can be a point of contract dispute. In other words, questions of whether a particular licensee product would infringe the patent but for the license, and hence fall within the standard clauses defining "licensed products," are as much contract term disputes (where the scope of patent is a contract term) as patent disputes (claim interpretation). In sum, the validity or enforceability of a patent is a matter external to the contract, as the basis of the license contract bargain is, again, merely the covenant not to sue by the licensor on whatever rights she may have on the defined patents. It may be that the patents are invalid or unenforceable – and most contemporary licenses (including that at issue in *MedImmune*) contain language terminating the licensee's royalty obligations at such time as the underlying patents are finally adjudicated to be invalid or unenforceable – but until that fact is established by a judicial proceeding, the licensee is paying for the licensor to refrain from exercising his legal rights to sue the licensee based on the patents at issue.<sup>207</sup> So there is simply

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206. See, e.g., NGUYEN ET AL., *supra* note 8, at 125-28, 211-12.

207. Recall that patents are presumed valid by patent law until they are invalidated. See *infra* p. 42.

no contract dispute where the licensee merely “believes” that the patents are invalid or unenforceable.<sup>208</sup>

Regardless of the issues raised in the foregoing, the Court only reiterated the rule in *Lear* – repudiating licensees do not have to comply with the license, no matter what its terms provide, and pay royalties while challenging the underlying patent.<sup>209</sup> Interestingly, the Court asserted that: “We express no opinion on whether a *nonrepudiating licensee* is similarly relieved of its contract obligation during a successful challenge to a patent’s validity – that is, on the applicability of licensee estoppel under these circumstances.”<sup>210</sup> This is fascinating because the *Lear* Court did seem to have been trying to eliminate licensee estoppel in all of its forms. In fact, MedImmune expressly relied on this position in its arguments before the Federal Circuit.<sup>211</sup> In the end, the *MedImmune* Court *did* accept MedImmune’s first odd conflated claim that it had a contract claim because it “‘disputes its obligation to make payments under the 1997 License Agreement because [its] sale of its Synagis product does not infringe any *valid* claim of [Cabilly II].’”<sup>212</sup> By couching the contract dispute in the proper question of infringement as discussed above, MedImmune made this sound like a contract term dispute. However, it was really arguing that part or all of the claims of Cabilly II were invalid, which should *not* have been interpreted as a contract dispute, but rather as a dispute over things external to the license agreement, i.e., patent law disputes. Questions of infringe-

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208. Note that all of this tracks the very different, but somewhat analogous, distinctions in assignor estoppel cases, where the equities have been held to prevent the assignor who later markets an infringing product from raising a defense of invalidity or unenforceability of the patent. In the assignor estoppel cases, courts held that the assignor could not sell something for value (land or a patent) and then turn around and deny valid title to that thing after the sale. Thus, courts have held that the assignor can contest whether his products in fact *infringe* the assigned patents, but not whether the patents are valid or enforceable. In the licensee case, the equities are very different as the licensee is not selling anything. However, the licensee is getting the benefit of the basis of the bargain so long as the licensor refrains from suing him for infringement based on the licensed patents and so there is no contract dispute over the validity or enforceability of the patents.

209. *MedImmune*, 127 S. Ct. at 769.

210. *Id.* at 769-70.

211. *See MedImmune*, 427 F.3d at 962-63.

212. *MedImmune*, 127 S. Ct. at 769 (emphasis added).

ment and questions of validity are two separate inquiries. The issue here should simply have been whether Synagis infringed any claims of Cabilly II on their face, presuming, as we must under the patent law, that they were valid. In the record, it appears that Synagis was indeed covered by the claims of Cabilly II as a *prima facie* matter.<sup>213</sup> The Court accepted MedImmune's equally weak bootstrapping argument that it had a contract dispute because even though the 1997 License Agreement clearly established that royalties must be paid until the patents were held invalid by a competent body, MedImmune was relying on the *Lear* Court's disregard of a similar requirement in that case and so MedImmune could argue to Genentech that it did not need to pay royalties – and hence had created a contract dispute – because the Supreme Court might also release it from this clear contractual duty (despite, of course, rulings to the contrary in the case of nonrepudiating licensees by the Federal Circuit).<sup>214</sup> The Court seems to be saying that a party can claim that the term “black” in a contract means “white,” or “day” means “night,” and, without any meaningful external support for these assertions, claim that it has raised a valid contract dispute.

Once the Court decided the “threshold” issue and found a live contract dispute (and perhaps a freestanding patent claim to boot), it moved on to decide whether MedImmune, as a licensee in good standing, had demonstrated enough of an actual controversy to bring its declaratory judgment action within the subject matter jurisdiction of the federal courts. The Court restated its own summary from an earlier case: “‘Basically, the question in each case is whether the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment.’”<sup>215</sup> It analyzed the issue as “but for” the payment of royalties, MedImmune would be under a real threat of immediate suit that would easily satisfy the criteria for a declaratory judgment action. Further, even though MedIm-

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213. Brief of Respondent Genentech, Inc. at 4, *MedImmune, Inc. v. Genentech, Inc.*, 127 S. Ct. 764 (Sep. 15, 2004) (03-CV-2567).

214. *MedImmune*, 127 S. Ct. at 770.

215. *Id.* at 771 (quoting *Maryland Casualty Co. v. Pacific Coal & Oil Co.*, 312 U.S. 270, 273 (1941)).

mune thus had it within its power to prevent any legal harm from befalling it, the Court asked whether this was enough to keep the situation from being considered a case or controversy.

The Court's analysis began with consideration of the situation where an individual can bring a declaratory judgment action against the state to challenge a law or its interpretation without violating that law first.<sup>216</sup> The justification was said to be because the citizen's compliance with the law was coerced on pain of criminal legal actions. This made the situation adversarial even though the government could not in fact take any action so long as the citizen kept complying with the law. While acknowledging that this kind of declaratory judgment action in the absence of any immediately actionable claim by the declaratory judgment defendant was rare when the government was not a party, the Court was able to come up with a few examples.<sup>217</sup> Disappointingly, though, the Court used *Altvater* as its model for deciding the instant case, misrepresenting it a bit along the way. It turned *Altvater* from a reasonable case that only held that courts must decide even declaratory judgment raised as counterclaims to a *valid infringement lawsuit brought by the patent owner* into an oversimplified holding that "a licensee's failure to cease its payment of royalties did not render nonjusticiable a dispute over the validity of the patent."<sup>218</sup> The Court did mention that the validity challenge was part of a counterclaim, and that licensees were paying royalties under protest due to an earlier injunction, but in doing so oversimplified and obscured the important connections and circumstances in the case.

As I analyzed *Altvater* earlier in this Article, I noted that it was critical to understand that: a) the injunction issued because Freeman successfully sued Altvater for producing infringing machines disallowed by their license agreement; b) Freeman's patent was largely invalidated in a suit with a third party after the suit with Altvater and so had to be reissued with markedly different claims from the original that Freeman had licensed and sued Altvater under; and c) Altvater continued marketing possibly different machines that Freeman believed

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216. *See id.* at 772-73.

217. *See id.* at 773.

218. *Id.*



infringed his reissued patent that presumably would have required additional royalty payments and/or a new injunction and so Freeman sued Altvater a second time. It is in the second lawsuit that Altvater raises the counterclaims as to not only invalidity and non-infringement, but also de facto termination of the original license once Freeman's original patent was largely invalidated and reissued and the absence or failure of a new one to take its place. It was to this last point that Altvater specifically looked for a declaratory judgment: He did not want it to look like his past practice of continuing to pay royalties indicated his acquiescence to either a continuation of the original license after the underlying patent had been largely invalidated, or to an implied or quasi contract newly arising on the basis of the reissued patent. Thus, at core, his defense to the new suit was not that the terms within the license contract were disputed, but rather that he disputed that the license contract was even still in force (or a new one had taken its place). To make that defense stick though, he had to explain why he continued paying royalties that prima facie made it look as if he believed a license contract was still in place. His explanation, then, was that until and unless he could get the injunction lifted from the original suit, he had to continue paying royalties *arising from the original infringing machines covered by that first suit*, else be liable for the treble damages of willful infringement under patent law because he had been adjudged as infringing a valid patent with those machines in the first suit. Therefore, Altvater was essentially arguing that things were very different after Freeman's original patent was largely invalidated and reissued and that he should not have to continue laboring under what was now a manifestly unfair injunction from the first suit. Accordingly, while the original court prevented Altvater from challenging the original patent in the first suit due to licensee estoppel,<sup>219</sup> the court in the second case allowed many counterclaims and affirmative defenses, *including a challenge to the reissued patent*, because there could be no licensee estoppel in the absence of a valid license agreement. I would reiterate, from my discussion of the licensee estoppel cases above, that courts are most susceptible to arguments to set aside or ignore license contracts or specific provisions thereof when something material has

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219. This is of course long before *Lear* largely abolished licensee estoppel.

changed in the background circumstances of the parties' license relationship. In *Altwater* something big did indeed change: Freeman's patent was largely invalidated and a very different set of substantially narrowed claims emerged in the reissue.

Finally, the declaratory judgment issue on appeal to the Supreme Court in *Altwater* was based on a partial reversal of the district court's ruling by the Eighth Circuit. The latter found that once the district court found the original license terminated (without a replacement) and there was no infringement under the reissued patents, the case or controversy had been resolved and so *Altwater's* other counterclaims in the form of declaratory judgment requests were mooted – *e.g.*, a finding of invalidity for the reissued patent – and should not have been granted by the district court. The Supreme Court believed that the Eighth Circuit had misinterpreted an earlier Supreme Court case that rebuffed a lower court for finding a patent was not infringed but still valid,<sup>220</sup> to mean that courts should not issue holdings broader than the specific issues raised by the *plaintiff*. The *Altwater* Court clarified the earlier holding by stating that it simply meant that courts should not stray beyond the actual issues raised by either party to the suit – so not just the plaintiff's claims, but also for example any counter- or cross-claims of the defendant. In the facts under *Altwater*, of course, *Altwater* had raised a number of counter-claims which then were properly adjudged in a decree by the district court and *improperly* removed from that decree by the Eighth Circuit.

Nonetheless, the *Altwater* Court desired to retain the guidance that courts not stray outside of their Article III jurisdiction by deciding questions where there was no case or controversy such as by issuing rulings on questions beyond those needed to adjudicate the dispute at hand. This led to the citation from *Electrical Fittings Corp.*<sup>221</sup> that was then bandied about (and largely misunderstood) between the majority and dissent in *MedImmune*. “[T]o hold a patent valid if it is not infringed is to decide a hypothetical case.”<sup>222</sup> As I discussed the quote

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220. See *supra* Part II(A).

221. See *supra* pp. 10-13.

222. *MedImmune*, 127 S. Ct. at 773 n.10; *id.* at 778, 780 (Thomas, J., dissenting) (quoting *Altwater v. Freeman*, 319 U.S. 359, 363 (1943)).

above,<sup>223</sup> it revolved around the distinction that because a patent owner must assert that its patent is valid (although this is presumed under the patent laws) *and* infringed, a patent infringement defendant need therefore only show that the patent is invalid *or* not infringed. In the case at issue, the lower court had dismissed the original bill on grounds of non-infringement of the patent *and then* went on to more or less gratuitously hold that the patent was valid. The *Electrical Fittings Corp.* Court stated that the non-infringement finding settled the matter and so there was no live case or controversy left to decide and so the validity question was mooted. Contrast this with the facts in *Altwater*, where *Altwater* had specifically raised a challenge to validity as a counterclaim. Thus, the *Altwater* Court distinguished the instant facts from those in *Electrical Fittings Corp.* because *Altwater* had properly made the validity question one that was part of the live case or controversy and thus needed to be adjudicated.

Under the facts in *MedImmune*, though, there were no judicial findings of validity and infringement of Cabilly II by *MedImmune* through its *Synagis* product. Accordingly, it was entirely speculative as to whether a court in a hypothetical future infringement suit brought by *Genentech* (and of course only on the further speculation that *MedImmune* stopped paying royalties someday thus opening the door for such suit) would find that *both* Cabilly II was valid and infringed by *MedImmune* through *Synagis* *and* that *MedImmune's* infringement was willful and hence liable for treble damages. It is critical to note that if that later court does *not* find willfulness, then it will likely only award damages that will roughly equal the reasonable royalties that would have been paid by *MedImmune*, plus interest and perhaps some other costs to make *Genentech* whole. This should not destroy *MedImmune*, especially as it was on notice that *Synagis* may infringe Cabilly II and so should have been laying up a cash reserve for potential litigation on this point. It is true that the hypothetical future court might find *MedImmune* to have willfully infringed Cabilly II – and certainly *MedImmune's* demonstrable knowledge of Cabilly II can help this finding – but this is far less certain, and thus far less of a “coercive” risk, than the likelihood that *Altwater* would have been found to have willfully

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223. See *supra* note 57.

infringed Freeman's original patent after a court had already in fact found Altwater's products to have infringed Freeman's (then) valid patent and issued an injunction addressing the same.

The foregoing leads to the heart of the disruption that the *MedImmune* decision throws into the licensing community: any party that knows of any patent that *may* cover its products knows that it is possible that a court could ultimately find it to have willfully infringed the patent and award treble damages to the patent owner; *MedImmune* appears to find that should that party decide to take a license to the patent instead, it will have been "coerced" into doing so and should then be seen to have an ongoing live case and controversy with the patent owner allowing it to bring a declaratory judgment action whenever it chooses. Where does this end? Does it matter if the prospective licensee discovered the existence of the patent on its own and approached the patent owner to request a license? Are there not times when organizations or individuals should have the courage of their (patent attorney's) convictions and simply not take a license when they believe that their products are not infringing or that the patent is not valid? Patent litigation may be "the sport of kings" due to its expense, and that may tip the balance for some individuals and organizations who might otherwise tell a patent owner to pound sand when given notice of a patent, but the policy issue is to address the cost of patent litigation, not to introduce the fiction that licensees were "coerced" into taking the license and paying the royalties "under protest" for purposes of allowing random declaratory judgment actions brought by licensees in good standing who cannot be sued by their licensors.

Further, where is the contract dispute in all of this that is supposed to be at the heart of actions under the Declaratory Judgment Act? There was a patent that your product may infringe, you took a license to hedge your bets (or even, honestly, because you knew that your product *does* infringe the patent), and now you are paying the royalties prescribed under the patent. What has changed or needs to be interpreted? In *Altwater*, something very big did change: the patent was largely invalidated and then reissued. By contrast, in *MedImmune* the only real change is that *Cabilly II* finally issued. However, *MedImmune* always knew the potential scope of *Cabilly II*'s claims, as well as the even wider potential scope of all claims

that might ultimately issue from the application for Cabilly I (including Cabilly II of course), and chose to take a license to the whole invention space marked out by this original application, explicitly including continuations, reissues, etc. Thus, how can it be a changed circumstance when a part of this invention space eventually does issue in a patent? It is true that MedImmune may well have started speculating that Cabilly II would never issue based on its conflict with Boss, and the long period of the interference may have helped this growing speculation, but it should have known better than to rule out a patent application until it is finally and decisively rejected (and such rejection affirmed by whatever appeals may follow). That it was wrong in its speculation over this does not magically generate a contract dispute over a license agreement that specifically included obligations on its part to pay royalties on any of its products that come within the scope of claims included in any patents issued under the original Cabilly I application as described above.

At best, MedImmune can argue that there is a contract dispute over whether Synagis in fact infringes or comes within the issued claims of Cabilly II. That would properly amount to a disagreement over terms of the contract (in this case the patent claims of Cabilly II would be the terms to be interpreted). MedImmune does not have a contract dispute over whether Cabilly II is valid, however, because there is simply no argumentation space around the fact that Cabilly II was issued as a continuation of the Cabilly I application. Therefore there is no need for an "interpretation" of a contract term that would have to read something like "licensee will pay royalties on products that would otherwise infringe a validly issued patent stemming from the Cabilly I application." If the latter provision were in the license agreement, then MedImmune could argue that there is a need for a court to interpret whether Cabilly II is "validly issued." There is no such provision, however, and at any rate such a provision might be seen as in some tension with the presumed validity of patents issued by the USPTO under patent law. Instead, the license at issue in MedImmune requires royalties for any products that would otherwise infringe any patents issued under the Cabilly I application, as described above, until the patent or claim under which the infringement arises is held invalid by a competent

body.<sup>224</sup> If such an event arguably comes to pass and MedImmune and Genentech cannot agree, in good faith,<sup>225</sup> about whether the patent or a claim has been invalidated in this manner, then that might perhaps be a scenario in which a declaratory judgment action by MedImmune might be proper. The problem in the actual facts of the case is that I think MedImmune knew that it would not be able to show that Synagis was not infringing, in the sense of coming within, the issued claims of Cabilly II,<sup>226</sup> but might have a better than even chance of successfully arguing the validity of Cabilly II based on the ample fodder for such an argument provided by the tortured prosecution and interference history of that patent. Understanding that it has a better *contract* dispute argument – a better avenue to justify a declaratory judgment action than a freestanding patent invalidity claim – by arguing a conflict over whether Synagis actually infringes Cabilly II, but realizing that Synagis likely will be seen as coming within the claims of Cabilly II as issued, MedImmune had little choice but to try and bamboozle the Court by hiding a validity challenge within an infringement challenge, i.e., “Synagis does not infringe Cabilly II because Cabilly II is invalid.” The Court should have seen through this subterfuge and affirmed the Federal Circuit’s ruling.

Only one major matter remained for the *MedImmune* Court, which was whether even if the contract dispute theory as described above was faulty, MedImmune should still have standing for its declaratory judgment action simply because it wanted to contest the validity of patent and was not precluded from doing so in any provision of the license agreement itself. As a preliminary matter, it must be noted that licensing practitioners generally believe that no-contest provisions in license agreements are unenforceable, I believe stemming from the rejection of just such as clause as manifestly unjust in *Pope*.<sup>227</sup>

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224. *MedImmune*, 127 S. Ct. at 769.

225. I remain extremely concerned about bootstrapped “contract disputes” arising from nothing more than silly or even bad faith attempts to generate conflict over terms or their application primarily to allow a declaratory judgment action, which of course results in some significant procedural advantages for the declaratory judgment plaintiff.

226. There is some suggestion of this in the briefs. See Brief of Respondent Genentech, Inc., *supra* note 213, at 4.

227. See *Pope Mfg. Co. v. Gormully*, 144 U.S. 224 (1892).

So to penalize licensors for not including something in a license agreement that they really cannot include because it is likely unenforceable as against public policy is a little odd. More importantly, the *MedImmune* Court refused to opine on whether the Federal Circuit's rulings that *Lear* only abolishes licensee estoppel for repudiating licensees makes it very difficult for the Court to do what it really wanted to do, which was to find that MedImmune would have standing for a declaratory judgment action solely on the basis of a freestanding, non-contract based claim of patent invalidity. Yet, it nowhere clearly said this and thus I do not believe its holding contains this proposition. Instead, the Court had to keep returning to the contract dispute rationales (as I believe it must for purposes of satisfying the requirements of the Declaratory Judgment Act). It rejected Genentech's appeal to the common law rule that a party to a contract cannot at one and the same time challenge its validity and continue to reap its benefits,<sup>228</sup> by responding that "[MedImmune] is not repudiating or impugning the contract while continuing to reap its benefits."<sup>229</sup> But of course, this is exactly what MedImmune is trying to do indirectly because it cannot do it directly: the net result will be that MedImmune will be able to disregard payments that would have been owed under the license agreement had it been forced to comply with the Federal Circuit's still untouched licensee estoppel rule for licensees in good standing. The Supreme Court itself has ruled against technical tricks that allows parties to achieve indirectly what they are prohibited from doing directly, as I described in the assignor estoppel cases above.<sup>230</sup> So why is it going to allow MedImmune to do that here? More importantly, if the Supreme Court does not like the Federal Circuit's rule limiting licensee estoppel to non-repudiating licensees in the wake of *Lear*, then it should have directly overturned this rule, rather than refusing to opine on the matter. As a matter of clarity in the law, the state of the law after *MedImmune* is not good: non-repudiating licensees may or may not be able to bring freestanding challenges to patent validity upon no trigger other than their own whim;

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228. See Brief of Respondent Genentech, Inc., *supra* note 213, at 16 (for an overview of Genentech's argument).

229. *MedImmune*, 127 S. Ct. at 776.

230. See *supra* Part II.

any licensee is free to bring a declaratory judgment action at any time based on any manufactured “contract dispute” so long as they can argue that they are not happy to pay royalties and thus were “coerced” into doing so; and, in any event, patent validity challenges can be disguised as scope of infringement disputes and thus contract disputes.

B. *Problems for Licensors in the Wake of MedImmune*

Alas, *MedImmune* is what it is, and until or unless Congress passes a constitutionally sound law modifying the outcome,<sup>231</sup> the licensing community must now strategize to find legal avenues to advance and protect their clients’ interests. The next Part of this Article will outline my proposal for a particular, but very important, niche of the licensing field that is most affected by *MedImmune*. Before turning to that, however, I want to briefly summarize where that decision has left us.

*MedImmune* holds that a licensee in good standing is not required to break or terminate (repudiate) its license before seeking a declaratory judgment in federal court that the underlying patent is invalid.<sup>232</sup> While not expressly opining on the validity of the Federal Circuit’s rule in *Gen-Probe* – i.e., that a non-repudiating licensee is estopped from challenging the underlying patent – the *MedImmune* Court seems to disfavor such a rule as it does not see any reason why the licensee is simultaneously getting the benefit of its license and challenging it at the same time by “simply” contesting the validity of the underlying patent. This of course ignores the favorable market position that the licensee is receiving under the license. The Court also seems to be willing to consider even fairly far-fetched, self-serving claims of “contract disputes” by a licensee in order to bring a declaratory judgment action. To be fair, the Court is not opining about the merits of the *MedImmune*-Genentech dispute, nor licensee challenge cases generally. It is only deciding whether such declaratory judgment actions must be dismissed for lack of subject matter jurisdiction. Further, the Court does not bar Genentech’s argument that

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231. Given the sentiments expressed in the last session of Congress and that anticipated for the current session, any hope of patent reform would most likely be directed against owner’s rights and powers rather than overturning the *MedImmune* decision.

232. *MedImmune*, 127 S. Ct. at 777.



courts are not required to hear declaratory judgment actions even if a party makes out a *prima facie* case, but leaves this for the lower courts to decide.

Returning to the license taxonomy from Part II above, I will now review how the different types of licenses, and their parties, are affected by *MedImmune*. First, settlement licenses, broadly construed, may be in jeopardy. For the subcategory of judicially imposed or recognized settlement licenses (*i.e.* entered into the record of a dispute as part of its adjudication or resolution), it is an open question whether the Federal Circuit's *res judicata* approach will continue to prevail, or whether the Supreme Court's apparent view that government "coerced" royalty payments made "under protest" give rise to a sufficient actual controversy ripe for a declaratory judgment action on the validity of the underlying patents. Hopefully, the Supreme Court will ultimately follow *Altwater* and require a significant changed circumstance, such as invalidated patents or claims from other proceedings, before allowing declaratory judgment actions at any time. If it does not so limit them, then patent owners can expect that so long as their patents have not been finally adjudicated as valid (and the defendant's products infringing), then the settlement may not "stick" but rather be susceptible to attack in a subsequent declaratory judgment action. The subcategory of settlement licenses arising from private enforcement or monitoring efforts will likely be even more susceptible to declaratory judgment actions as there will be little argument of *res judicata* availing to the patent owner. Further, as the courts have been willing to broadly interpret the imminent threat of suit standard to include even patent notice letters that are not in the form of a cease-and-desist, targets of such enforcement or monitoring efforts will likely have wide leeway to choose the timing of a declaratory judgment action: anytime from receipt of the original letter or contact until years into any license resulting from the ensuing discussion, including before or after royalty payments have started.

Second, deal licenses may fare even worse. At its most elemental, the rule emerging from *MedImmune* seems to be that non-repudiating licensees, no matter what the origins or impetus of the license agreement, can seek a declaratory judgment in federal court at any time to find that the underlying patent is invalid, unenforceable, or not infringed. Under the Court's

broad interpretation of what it means to be “coerced,” all licensees can argue that they did not enter the license and pay royalties with pleasure, but rather because there was some explicit or implicit threat of private legal action by the patent holder lurking behind even the most “voluntary” deal. I wonder whether the Court will even find coercion where a prospective licensee approaches a patent owner out of the blue because it wants to license the owner’s patent to start a new business or product line? Notwithstanding any possible coercion in the origins of the license, the *MedImmune* Court seems to find coercion even later in the license relationship where a voluntary licensee, perhaps even one as described in the preceding scenario, decides that it now believes the underlying patent to be invalid or not to have covered his product at all; but when the licensor does not agree to release him from all harm and not enforce the patent, the licensee decides to continue paying the royalties, only now “under protest.” Never mind whether the licensee undertook due diligence in examining the patents and considering the nature of his products before entering into the license. So, coercion and contract disputes can now arise in any kind of deal license and at any time. And, even more so than settlement licenses arising from private enforcement activities, deal licenses will have none of the possible protection of *res judicata*.

All of this brings us down to the real issue for patentee/licensors: will they receive fair compensation for their licenses? Essentially, after *MedImmune*, this breaks down into three different time frames. Working in reverse chronological order, the post-adjudication period is potentially a win big, lose big period. At this point, either: (i) the patents have been held invalidated, unenforceable, or non-infringed and, from the case law, we know that no matter what the license contract says, the licensee will not be obliged to pay anything else; or (ii) the patents will have been held valid, enforceable, and infringed, and the licensor can expect to receive full royalty payments (plus possibly treble damages if the licensee repudiated and did not have reasonable justification for its position), although it might have to resort to further judicial proceedings to actually extricate the money from the licensor. Further, the licensor has a “certified” patent now that, barring newly produced prior art, should command higher license fees and royalties in the marketplace, as well as discourage other of its

licensees (or prospective licensees) from challenging the patent. In the extreme, one might imagine a licensor structuring a license to require only a “discounted” royalty rate for unchallenged patents, but then increasing that rate after successfully defending the validity of her patent, whether from a challenge by a third party or the licensee itself.

The second time frame is the pre-adjudication, but post-challenge period, by which I mean the time after a declaratory judgment action or other legal challenge was filed but before the final ruling in that (or any similar) proceeding. This period may present the most unexpected risk for the licensor, as she may be under the false belief that she can still demand royalties during the proceeding and up until its conclusion. However, we know from the case law that repudiating licensees are not liable for payments during this period (unless the patent is finally validated and infringement found). Non-repudiating licensees who now have the ability to challenge the patent at essentially any time may be deemed to fall under the same rules as repudiating licensees, because the test seemed to be when/whether the licensee had registered its challenge to the patents. So, it may be that no licensees are liable for royalties from the time when they take action on their patent challenge, in whichever recognized form they use – unless, of course, their challenge is ultimately unsuccessful.

The third time frame runs from the execution of the license until any challenge is mounted. In theory, it should be the most certain period for payment of expected royalties to the licensor, but in a number of cases the expected royalties for this period may turn out to be none. Why? Because in many license arrangements – mainly deal licenses – the licensee took the license *before* it either developed a product or was ready to start distributing it. Thus, whether royalties are calculated based on units sold or net sales receipts, no royalties are owed if no products are being sold.<sup>233</sup> It is precisely when the licensee begins to sell units and realize revenues that the patent challenge is likely to occur. Quite possibly then, a licensor could find itself having incurred the opportunity cost of granting an exclusive license to a company to commercialize the

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233. Sometimes licensors will use “minimum royalty” requirements that require a licensee to pay some floor level of royalties regardless of units sold just to keep the license. NGUYEN ET AL., *supra* note 8, at 116.

licensor's patent – meaning it is placing all of its patent profitability bets on one licensee – and then have the licensee challenge the patent just when the licensee has developed a product under the legal safety of the license.<sup>234</sup> The opportunity cost is higher than you might think as well. It is not only that the patentee could have had someone else trying to commercialize its patent in the time it was exclusively licensed to the now dead beat licensee, but also that very few companies may be willing to take a license from the patentee *after* all that time has passed and there is a taint to the patent. Certainly, an active patent challenge in court is going to severely depress the market value of the patent to prospective licensees. But those companies may also wonder whether the original licensee has now developed some other enhancement or other protectable IP that will be asserted against the new licensee. Finally, in the high tech world, the window may simply be closing for the patented technology by the time all of this has run its course.

In the end, the *MedImmune* position is maddening for patentee/licensors because it creates a primarily one way path for litigation – from licensee as plaintiff in a declaratory judgment action. Because the licensee has not repudiated the agreement, the licensor is blocked from suing the licensee by its own covenant not to sue at the heart of the license. This is like blocking a landlord from evicting a tenant who is trying to burn down the apartment house to collect renters insurance. It is true that the licensor does not have to be caught completely flat footed. It can, for example, include a termination clause in its licenses that allows it to terminate the license upon any challenge of the patent by the licensee.<sup>235</sup> At least this ameliorates the one way litigation problem as it would, in theory, allow the patentee to sue the licensee. In practice, however, in the wake of *MedImmune*, licensees will likely not

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234. But for the license, the licensee would have been liable to the patentee for infringement *and* subject to injunctive relief. So, while the measure of damages will be small during the R&D period (no products sold, no revenue, no reasonable royalties), the real threat to the commercializing party is the potential for an injunction which will prevent it from proceeding any further on the project – even if it has already expended its own substantial R&D outlays.

235. Note that these are *not* no-contest clauses that would contractually bar the licensee from challenging the patent – such as were rejected by the Supreme Court in *Pope*.

challenge the patent in any other way than a declaratory judgment action, thus effectively depriving the licensor of any meaningful opportunity to take control of the litigation as plaintiff by suing the licensee first. The termination clause does have the additional benefit of at least depriving the licensee of the coverage of the license if the patent challenge fails. But this may be of little practical value. The non-exclusive licensor may find all of this somewhat less problematic as it need not have incurred the same opportunity cost as an exclusive licensor. For the non-exclusive licensor, it may be enough that it can terminate the license upon a challenge by the licensee and then hope to collect some money from the licensee later if it succeeds in defending its patent.<sup>236</sup> For the exclusive licensor – especially socially beneficial non-commercializing patent owners like universities, non-profit research centers and small inventors – the problems presented by *MedImmune* are not so easily handled or taken in stride.

For exclusive licensors like those just mentioned, the world has been radically changed, and so it is primarily for them that I propose a solution in the final Part of this Article. Before doing so it is important to flesh out this niche of licensors that I am most concerned about and whom I believe deserve a better understanding of the equities involved in their license relationships than that evinced by both the *Lear* and *MedImmune* Courts. As a preliminary matter, whatever one's concerns about "patent trolls," the coarse definitions of trolls as any patent owner who does not manufacture his own products is just plain silly. Much core innovation and invention is achieved by individuals or organizations who are simply not set up, by design or accident, to commercialize their valuable insights. Universities, for example, are probably the best example of this, but the government itself is a good example too. In fact, the Bayh-Dole Act was passed in large part to reduce the amount of innovative research being performed by universities and others under federal funding that was languishing "on the

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236. This is at least the position of Microsoft so far, which now has an extensive licensing program. Lisa Tanzi et al, Microsoft Counsel, Remarks at the Licensing Executives Society Luncheon (Jan. 17, 2006) (as noted by author as attendee). Note, however, that the single challenge, if successful, could bring down the whole set of royalties for the non-exclusive licenses under that patent. Of course, if the patent is truly invalid then this is the proper outcome anyway.

shelf,” so to speak, because there was no clear, predictable mechanism to transfer the research results out to the public for commercialization.<sup>237</sup> Bayh-Dole gave the funding recipients the right to elect to take the title to any patent arising from the funded research, *so long as* the recipient then took timely affirmative steps to bring the patented invention to “practical application” – which meant either direct commercialization or licensing it out for commercialization.<sup>238</sup> Universities and non-profits who essentially never directly commercialize their inventions are the main target of Bayh-Dole. Thus the role of licensing figures prominently in the Act, and licensing requirements – such as preferences for small businesses as licensees and “substantial manufacture” in the United States – are scattered throughout the Act. Accordingly, if universities and other non-commercializing non-profits are “trolls” then they are government sponsored trolls.

More importantly, the deal licenses struck between universities and other non-profit research organizations on the one hand, and private industry on the other, are primarily positive, completely voluntary – indeed socially desirable – “tech transfer” agreements that incentivize and allow key research breakthroughs to be transformed into valuable products and services for public consumption. Without such tech transfer licenses, arguably much of the life saving new technologies originating in university labs would never become available to you or me in the form of safely deliverable medicines or devices administered by health care professionals. Therefore, to view these licenses as “coerced” and thus undesirable in some way is to seriously misunderstand the licensing environment and the manner in which contemporary technology products and services get to market. Far from being coerced and/or

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237. Prior to the passage of Bayh-Dole, many federal funding agencies retained the rights to inventions arising under their funding. Thus, just prior to the passage of Bayh-Dole these agencies collectively held 28,000 patents, of which only 4% had ever been developed as a product for use by consumers. Senator Birch Bayh, Statement to the National Institutes of Health (May 25, 2004), available at <http://ott.od.nih.gov/Meeting/May25.htm>.

238. Pub .L. No. 96-517, 94 Stat 3015 (1980) (codified at 35 U.S.C. § 200 to 212 (2006)). See also O'Connor, *The Use of MTAs*, *supra* note 10; Sean M. O'Connor, *Intellectual Property Rights and Stem Cell Research: Who Owns the Medical Breakthroughs?*, 39 NEW ENG. L. REV. 665 (2005).

undesirable, these deals in fact are essential to getting socially beneficial research results from bench to bedside.<sup>239</sup>

In part due to Bayh-Dole's preference for licensing to small businesses, and in part due to the realities of the market place for licenses of the very early stage technologies that arise in university and other research settings, many tech transfer agreements involve small to mid-size entities (SMEs) as licensees.<sup>240</sup> These companies rarely have large amounts of cash on hand and thus rely on the running royalty license structure to secure tech transfer licenses.<sup>241</sup> Further, because of their often cash-poor situation, they usually need to minimize any up front license payments to the university or other patent owner.<sup>242</sup> Thus, the university is extending them a kind of credit – in exchange for the possibility of royalty and perhaps milestone payments down the road, the university will grant them a valuable exclusive license now with which they can safely and exclusively engage in the expensive commercialization R&D to bring products based on the patent to market.

However, the Supreme Court's holding in *MedImmune* threatens to seriously upset this standard tech transfer bargain. It allows the licensee to take the license on "credit" and then challenge the underlying patent once the licensee has successfully commercialized products under the license and payment for the "credit" comes due, all without jeopardizing its privileged position under the license vis-à-vis both the university and the market place. Universities could start including clauses in their tech transfer licenses that terminate the license on any such challenge, but this would still not undo the substantial harm based on the lost opportunity cost the university incurred by committing the patent exclusively to the licensee for what might have been years of critical R&D. What other industry party will now take a license to this patent – keeping

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239. There are, of course, some criticisms of Bayh-Dole and the tech transfer system it helped to create. However, a discussion of those criticisms, and the responses to them, is beyond the scope of this paper. For a fuller discussion, see O'Connor, *The Use of MTAs*, *supra* note 10; O'Connor, *Intellectual Property Rights*, *supra* note 238.

240. See F. Kinsey Haffner et al., *University Technology Transfer Rights*, in *INTELLECTUAL PROPERTY TECHNOLOGY TRANSFER* 203, 262 (Aline C. Flower ed., 2006).

241. See *id.* at 256.

242. See *id.*

in mind that the patent is now both under challenge (whether meritorious or not) *and* the former licensee may be holding potential new patents or applications that will effectively block any commercialization path of new licensees?

In summary, throughout this Part of the Article, I have argued that the *MedImmune* decision affects licensors across the spectrum. While I do not agree with much of the *MedImmune* holding and opinion, I do acknowledge that bad patents and malicious, fraudulent, or extortive would-be licensors should not be allowed to hide behind any kind of bright line licensee estoppel doctrine or its equivalent. My point is that licensee estoppel and many of the other license issues debated in the *Lear* to *MedImmune* sequence of cases are equitable doctrines that should be treated as such, i.e., by weighing the equities on a case by case basis, rather than relying on bright line rules or absolute bars. In other IP cases, such as *EBay v. MercExchange*,<sup>243</sup> the Supreme Court has been making exactly this point in the face of what appear to be bright line rules and absolute bars created by the Federal Circuit as the latter exercises its privileged position to hear all federal district court patent appeals. It is unclear why the Supreme Court did not follow this inclination in *MedImmune*. Nonetheless, my hope is that the Court will in the future be more inclined to consider the considerable equities that one niche of licensors – virtuous non-commercializing innovators such as universities – has for the kinds of deal licenses that they must rely on to commercialize their valuable and socially useful technologies. In the meantime, I conclude the Article in the next Part by setting out in concrete terms a strategy that these kinds of licensors can deploy to mitigate the bad spot that the *MedImmune* decision has put them in.

#### IV.

##### (RE)BUILDING EQUITY: USE OF STOCK AND STOCK OPTIONS TO SAFELY MIMIC EXPECTED RUNNING ROYALTIES FOR LICENSORS

One easy sounding response to the licensor's problem created by *MedImmune* is that licensors must simply demand all of the expected life time value of the patent license up front.

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243. *EBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837, 1839, 1841 (2006).



That way, the licensee can do what he wants – challenge or not challenge – and it's all the same to the licensor. Nothing in the law prevents a patent owner from collecting one up front licensing fee.<sup>244</sup> However, upon reflection, this presents a few hurdles. First, it may be quite hard to determine with any sense of accuracy the net present value of an expected royalty stream. In cases where the patent owner always viewed his patent as having some fairly fixed market value, then he might just as easily decide that this is the upfront license fee. And, one might expect that patentees who have that kind of valuation in hand already try to either assign or exclusively license the patent for a single up front payment. However, not all (or even perhaps many) prospective assignees/licensees have enough cash on hand to pay this upfront fee, unless the patent's value is fairly low. Thus, based on any combination of the foregoing, many patent owners have found it best to take some relatively modest up front fee and then receive the rest of their compensation in the form of royalties, sometimes tied to milestones or other events inside or outside the licensee's organization.<sup>245</sup>

In truth, this overall package may be based on some ballpark estimate of the total lifetime value of the patent, but the royalty mechanism allows this rough estimate to be self-correcting, to some degree, over time. The rough estimate of the overall value of the patent can be used instead as a starting point to propose what the upfront payment and royalty rate should be, rather than just picking the numbers out of thin air.<sup>246</sup> Of course, the patent owner has to deal with the realities of the licensing market. For example, many industries have fairly standard royalty rate ranges.<sup>247</sup> Further, licensees often undertake their own evaluation of the patents ahead of the negotiation and use any evidence of weakness (meaning

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244. See NGUYEN ET AL., *supra* note 8, at 113-17. See generally U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (1995).

245. See NGUYEN ET AL., *supra* note 8, at 113-17.

246. Although anecdotally I know that a fair bit of that happens as well!

247. In the university and non-profit research tech transfer sector, for example, the archives of listservs such as Techno-L provides an excellent source of "standard" and actual royalty rates as attested to by tech transfer staff at major research institutions. Techno-L, <http://www.techno-l.org/> (last visited Apr. 23, 2007).

susceptibility to invalidation) to bargain down the up front payment and/or royalty rate. In other cases, the patent is on such an early stage or “upstream” invention that the risks of successful commercialization are higher and R&D will be more costly and time consuming to the licensee, so the overall compensation package is ratcheted down. The reader can follow out this line of thought and consider other ways that prospective licensees can barter down the desired compensation of the patentee.

The upshot of all of this is that it will often simply not be feasible for a patentee to receive all of the value of the patent license up front in cash.<sup>248</sup> Additionally, many prospective licensees may simply be uncomfortable with committing to an entire non-refundable pay-out at the beginning of the license term when they do not yet know how many units of the covered product they are actually going to sell or the per unit price. For the licensor, though, once a substantial portion of the total expected returns from the licensing deal are pushed out to royalty payments, then, particularly in the case of non-commercializing patentees who rely on exclusive licenses, *MedImmune* poses a huge additional risk to the licensor’s expected returns. Thus what is required is a way to essentially transfer all of the *potential* returns to the patentee at the execution of the license agreement in a way that unlocks the value to the licensor over time. This should be somehow connected to the success of the licensed product, but without any material ability for the licensee to block the unlocking of value over time through patent challenges, license challenges, or otherwise.

As the reader already knows from the title of this Article and Part, my proposed solution is to use a combination of stock and stock options to execute this value transfer. The use of each will correspond to a different time horizon of opportunity; collectively the package will coarsely mimic the performance related payout that would occur under a royalty scheme,

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248. *But see* Press Release, Emory University, Gilead Sciences and Royalty Pharma Announce \$525 Million Agreement With Emory University To Purchase Royalty Interest For Emtricitabine (July 18, 2005), *available at* <http://www.news.emory.edu/Releases/emtri/> (announcing a one time cash payment of \$525M to essentially pay the net present value of the expected lifetime royalties for Emory’s patent on emtricitabine).

but without the patent challenge and repudiation risk in the post-*MedImmune* era. The primary benefit is that all of the stock and options can be transferred and owned by the licensor immediately upon execution of the license. At the same time, contingencies can be built into the options, as discussed below, to provide the value unlocking function over time, tied to events at the licensee's organization, but not dependent on separate administrative actions by the licensee to effectuate the value unlock, and certainly not dependent on permissions or blocking efforts by the licensee.<sup>249</sup> Before considering the exact mechanism of my proposal, however, it is critical to establish the primary types of securities used by SME high tech companies and their strengths, limitations, and regulation.

A. *Types of Equity Stakes and Their Implications for Investors*

We must first consider the value of stock or other equity to the licensor as an investor. Like patents, equity stakes have to be valued somehow since they are not cash equivalents. Pricing stock and other equities can be simplistic – for a public traded company, the value of its trading stock is simply the price it sells for in the open market at any given time – or very complicated – using methods such as the Black-Scholes Option Pricing Model to figure out the dollar value of stock options at a future date.<sup>250</sup> Beyond all of this, however, is an even more fundamental issue: how does the investor turn stocks into cash? At some point, essentially all investors or their heirs will be converting stock into cash because it is overwhelmingly cash that allows us to buy other things (unless you are a company that can buy another company with nothing but your own stock). The only real question then is when to sell.

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249. Technically, this last part is not entirely true. When the licensor exercises her options or warrants, she does need to rely on someone at the licensee company, such as the corporate secretary, to accept her money (where applicable) and then issue her the corresponding stock. However, it is probably safe to assume that a company is not going to start playing around with dishonoring binding stock options, which could cause other critical investors to run panicked for the exits.

250. See, e.g., Simon Benninga & Zvi Wiener, *Binomial Option Pricing, the Black-Scholes Option Pricing Formula, and Exotic Options*, MATHEMATICA IN EDUCATION & RESEARCH, Vol. 6, No. 4., 1997, at 1, available at <http://finance.wharton.upenn.edu/~benninga/mma/MiER64.pdf>.

Or, to augment that, the only real questions might be when *and how* to sell. Most average investors are only buying publicly traded shares in the secondary capital markets. In other words, they are not buying shares directly from the company (“issuer” in securities law parlance),<sup>251</sup> but rather from other investors who currently hold the issuer’s shares in transactions mediated by broker-dealers,<sup>252</sup> usually in a formal market or stock exchange<sup>253</sup> such as NASDAQ<sup>254</sup> or the New York Stock Exchange.<sup>255</sup> These shares in nearly all cases were originally made available for public trading in the secondary markets by the issuer through an initial public offering (IPO) or subsequent public offering in compliance with the Securities Act of 1933<sup>256</sup> and Regulation C<sup>257</sup> promulgated by the SEC thereunder. Once the shares were initially sold in just such a primary capital market offering – either direct to investing members of the public or through underwriters<sup>258</sup> and then to the public – they then became freely tradable in the secondary markets. Accordingly, they can be a highly liquid investment that can be disposed of quickly if necessary.<sup>259</sup> However, shares sold directly to investors not involving a registered public offering under the Securities Act of 1933 and Regulations C (usually called a “private placement”) cannot be resold with-

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251. See 15 U.S.C. §77b(a)(4) (2000) (defining “issuer” under the Securities Act of 1933).

252. See 15 U.S.C. § 77b(a)(12) (defining “dealer” under the Securities Act of 1933); 15 U.S.C. § 78c(a)(5) (2000) (defining “dealer” under the Securities Exchange Act of 1934).

253. See 15 U.S.C. § 78c(a)(1) (2000) (defining “exchange” under the Securities Exchange Act of 1934).

254. NASDAQ, <http://www.nasdaq.com> (last visited Apr. 23, 2007).

255. New York Stock Exchange, <http://www.nyse.com> (last visited Apr. 23, 2007).

256. See 15 U.S.C. §§ 77e-h (2000) (specifying securities offering requirements).

257. See 17 C.F.R. §§ 230.400 to -494 (2006).

258. See 15 U.S.C. § 77b(a)(11) (2000) (defining “underwriter” under the Securities Act of 1933).

259. This is especially true for stock of major publicly traded issuers for whom there are usually “market makers” – brokers or dealers who make themselves available to buy and sell the stock of the particular issuer on their own account (meaning not for customer’s accounts, and hence subject to customer buy or sell orders). See 15 U.S.C. § 78c(a)(38) (2000) (defining “market maker” under the Securities Exchange Act of 1934).

out registration under the Act or an exemption therefrom.<sup>260</sup> In fact, the original private placement itself must have occurred under one of the exemptions from § 5's registration requirements<sup>261</sup> – either because the *security* belongs to the class of exempt securities identified under § 3,<sup>262</sup> or because the *transaction* was exempt under § 4.<sup>263</sup> If the private placement shares were exempt securities under § 3, then they generally have no restrictions on their resale as they are always exempt from the registration requirements of § 5. However, a private placement involving shares that are not exempt shares, and thus was effected through an exempt transaction under § 4, results in “restricted stock” that cannot be resold unless the shares are subsequently made part of a registered offering under § 5 or the resale itself can be structured to fall under a transaction exemption under § 4.<sup>264</sup>

While a full discussion of the nuances of securities law regarding private placements and the resale of restricted stock is beyond the scope of this Article, the take away point is that investors who purchase restricted stock often find themselves with a somewhat illiquid investment, because they cannot simply turn around and sell it at any time through a broker-dealer as they could do with other publicly traded holdings. Further, because the categories of exempt securities in § 3 primarily consist of things such as municipal securities, private placements of regular for profit corporations' stock generally must be structured as an exempt transaction under § 4,<sup>265</sup> and thus result in restricted shares for the investors. This will be especially relevant for my university and non-profit patent licensors because a high percentage of SME high tech companies will be privately held. Accordingly, the stocks of these companies

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260. See Regulation D, Rule 502(d), 17 C.F.R. § 230.502(d) (2006).

261. 15 U.S.C. § 77e (2000).

262. *Id.* § 77c.

263. *Id.* § 77d.

264. See 17 C.F.R. § 230.502(d).

265. Notable exceptions are Rule 504(b)(1) in Regulation D (but this is limited to private placements not exceeding \$1M in the aggregate), *id.* § 230.504(b)(1), and Regulation A (which requires a “mini-offering” that may be almost as expensive and time consuming as a regular registered public offering under section 5, 15 U.S.C. § 77e. See *id.* §§ 230.251(d), 230.252-230.253.

will be far less liquid in the marketplace, and in some cases there may be no real market for the shares.

Outside of the purely legal restrictions described above, private placement securities may have other restrictions because they are usually sold as part of a negotiated private placement deal, such as a venture capital financing round, and are subject to certain contractual rights and obligations under investor rights agreements or shareholder voting agreements.<sup>266</sup> Additionally, much of the private placement equity will be in the form of preferred stock, which may or may not be convertible into common shares of the issuer, but will almost certainly have special rights and preferences (as compared to common stock) as defined in either the issuer's articles of incorporation or bylaws.<sup>267</sup> While the preferred stock issued by large, established companies may often have some preferential financial treatment as compared to common stock – perhaps a fixed dividend – it may also have reduced voting rights.<sup>268</sup> This is often *not* the case with preferred stock issued by SMEs in the high tech space: venture capitalists will demand preferred stock with financial preferences *and* voting rights equal or superior to those of common stockholders.<sup>269</sup> As to the financial preferences, the venture capitalists will generally be looking for liquidation preferences, in which they receive a fixed payout from any assets left upon liquidation or dissolution of the company *before* any similar payouts to common stockholders, or other subordinate preferred stock series holders.<sup>270</sup>

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266. See Edwin L. Miller et al., *Venture Capital Financings of Technology Companies*, in *INTERNET LAW AND PRACTICE* § 3:17 (West 2002).

267. See *id.* §§ 3:10, 3:17.

268. MICHAEL D. SINGER, *THE POCKET MBA*, “Preferred Stock” (Practicing Law Institute, 2003).

269. See generally Miller et al., *supra* note 266 §§ 3:10-3:17.

270. *Id.* § 3:11. Note that upon a liquidation, remaining assets must be distributed first to the government for any taxes or assessments due, second to creditors, and third to equity holders. Thus, in many cases there will be no assets left to distribute to any shareholders. But in the event that there are, then preferred stock holders would like to be senior to other stock holders. See generally *id.* Issuers are generally free to classify their stock into different classes, with different series within a class if desired. See, e.g., Wash. Rev. Code § 23B.06.020 (2007). The articles or certificate of incorporation of the issuer generally may either define the rights and preferences of any preferred classes or series or may delegate this power to the board of directors. See, e.g., Wash. Rev. Code § 23B.06.010, 020 (2007). Classes or series

A further set of conditions on preferred or common stock that is not registered for public sale under the securities laws may appear in the contracts mentioned above – investor rights agreements and shareholder voting agreements – that often accompany the core stock purchase agreement at the heart of the private placement deal as follows. A Right of First Refusal and Co-Sale agreement will often be included which may include “tag-along” and/or “drag-along” rights. In the former, the shares of a group of shareholders (often a venture capital syndicate, together with some ancillary investors) are tied together such that if one shareholder has a buyer and wants to sell his shares, he has to notify the others and they have the right to buy his shares instead, or they can demand to “tag-along” and require that the outside buyer purchase all the shares or none.<sup>271</sup> Obviously this can be a deal killer for the outside buyer. Drag-along rights are sort of the mirror image of tag-along rights. In this case, a shareholder of the syndicate has found an interested buyer, but the buyer only wants to buy all of the shares of the syndicate, or at least some number greater than what the selling shareholder holds. If drag-along rights apply, then the selling shareholder can require all of his fellow syndicate investors, or enough to reach the number of shares that the outside buyer requires, to sell some or all of their shares.<sup>272</sup>

The question then is how investors who hold restricted stock, such as preferred stock purchased in a venture capital private placement, cash out their position. The obvious path would seem to be an IPO, yet, for existing shareholders, this is not exactly the direct payoff that the lay person might expect – especially if the investor did not get the right contractual provisions in place when she purchased the shares. As discussed above, for private placement restricted stock to trade freely in the secondary markets, it still needs to be part of a registered offering. In other words, just because a company has had an IPO does not mean that *all* of its shares are now freely tradable. Instead, the investor needs to make sure that *her* shares will be either included in the IPO (unlikely as IPOs generally

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can generally be made senior to other classes of series for things such as distribution or liquidation payouts. *Id.*

271. See Miller et al., *supra* note 266, § 3:17.

272. See *id.*

focus on *primary* market offerings, from the issuer to investors, not secondary market transactions from investor to investor) or a follow-on public offering or later registration. Further, for maximum liquidity of the shares, the investor needs the issuer to “list” or register the shares on a major market or exchange, such as NASDAQ or the NYSE, too. The bottom line is that investors who bought pre-IPO or other unregistered shares need to have a contractual registration right that allows them to demand that the company register their shares upon the occurrence of certain events.<sup>273</sup> Further, for preferred shares that almost never get registered in a public offering – probably because their special rights and preferences would drag down the liquidity they would otherwise get in the public secondary markets due to the literal information costs accompanying them – investors need to make sure that their shares will either automatically convert or that they’ll have the right to convert them to common shares in advance of, or upon, the effective date of the IPO.<sup>274</sup> Once the preferred shares have been converted to common, then the investors can exercise their registration rights, demand registration of their shares by the issuer, and, once that is effected, finally begin selling them in the public secondary markets.

The IPO and public trading of the investor’s shares is not the only avenue for the investor to cash out her position. In some cases, SMEs will be acquired by a larger company. If the investors are lucky, the acquiring company will be offering cash to buy their shares to effectuate the acquisition.<sup>275</sup> In other cases, the acquiring company will be offering its own stock in exchange for the investor’s stock in the target company, or perhaps a combination of cash and stock. In this scenario, the investor must decide whether the acquiring company’s stock is worthwhile to hold for the long term as part of

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273. *See id.*

274. *See id.* §§ 3:14, 3:17.

275. Note that since stock is generally considered to denote an equity or ownership stake in the entity, the stockholders are collectively the only owners of the entity. Even founders of the company must hold stock to be considered owners. Thus, for one company to acquire another, it must acquire ownership or title to the target company’s outstanding stock. When it acquires all of that stock, the target becomes a wholly owned subsidiary; when it obtains only a controlling part of the outstanding stock, the target becomes simply a subsidiary.



a diversified investment portfolio, or whether it should be sold for cash. If the acquiring company is itself privately held, then the investor may be in no more liquid a position than when she held the stock of the original target company. However, provided that the acquiring company is publicly traded, and offers publicly tradable registered shares in the merger, then the investor can simply cash out by selling her newly acquired stock in the secondary markets.

The foregoing scenarios all assume that the merger is effected by a stock purchase. Yet, the classic merger is a statutory merger in which the two companies actually become one by an act of law.<sup>276</sup> In this case, depending on which company is designated as the “surviving corporation,”<sup>277</sup> the investor may continue holding restricted stock in her original company.

The final major type of merger is not really a merger at all, but an asset sale. This has benefits for the acquiring company in that it will not be taking on any outstanding or accrued liabilities or obligations of the target company. Instead, it can simply buy the assets of the target, in some cases with management and personnel intact. From the perspective of an investor who wants to be cashed out, this might seem to be the same as a stock or cash purchase merger, but the critical distinction is that in the asset sale the target *company* receives the stock or cash payment. Thus the investor still owns the same stake in her original company as she started with. However, since the company may now hold nothing other than cash and/or the “acquiring” company’s stock, its shareholders may be able to compel the board of directors to distribute this cash or stock and dissolve the company.

Finally, even if neither an IPO nor a merger is in the works, but the investor needs to cash out, she may still be able to under either a private sale of her stock or exercise of a redemption right, if any. The safest way to structure a private sale is by complying with the provisions of Rule 144<sup>278</sup> or Rule 144A,<sup>279</sup> promulgated by the SEC under the Securities Act of 1933. Under the former, the investor has to meet the require-

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276. *See, e.g.*, Wash. Rev. Code § 23B.11.010 (2007).

277. *See id.*

278. 17 C.F.R. §230.144 (2006).

279. 17 C.F.R. §230.144A (2006).

ments of the rule to ensure that she is not considered an underwriter involved in a distribution of the stock, and thus the transaction can be properly exempted under § 4(1).<sup>280</sup> Under the latter, the transaction is exempt from the registration requirements of § 5 so long as the investor is selling only to a “qualified institutional buyer.”<sup>281</sup> The main challenge with both of these is not so much structuring the transaction correctly, but instead finding willing and appropriate buyers. The markets for unregistered stock are thin and thus the stock is nowhere near as liquid an investment as stock of a publicly traded company, especially where one or more market makers are ensuring a ready market for the latter. Finally, the investor may also have a “redemption right,” which requires the issuer to buy back some or all of the investor’s stock upon certain triggers.<sup>282</sup> However, this right may simply refund the original purchase price of the stock, or pay out some modest amount over that price. It is not exactly the big return on investment (ROI) that an investor is looking for; instead it is probably best viewed as some downside protection similar to liquidation preferences.

Now that we have established the basic parameters of the types of stock held by SME high tech investors, I can outline my proposal for how to use stock and options as a substitute for running royalties. However, based on the foregoing, it is important for potential licensors to understand just how liquid (or illiquid) their investment is. This should certainly be a factor for any licensor who needs cash in hand sooner than some eventual IPO or other exit event.

B. *Structuring Stock and Options as an Up-Front Royalty  
Payment to Approximate Running Royalty Returns  
Over Time*

With all of this in mind, we can now turn to the breakdown of the different equity positions needed to turn my stock and option payment plan into the rough functional equivalent of a running royalty. First, the parties would negotiate the deal as if it were a standard running royalty deal license and settle on the amount of the upfront license fee payment and

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280. 15 U.S.C. § 77d (2000).

281. 17 C.F.R. § 230.144A.

282. See Miller et al., *supra* note 266 § 3:16.

the royalty rate. Second, the parties would negotiate whether the upfront license fee payment is to be made in cash or stock. This does not matter much for my purposes as the up-front license fee payment is committed and paid upon execution of the license, so for all intents and purposes no matter what happens later the licensor retains this payment. If pushed, I suppose I would suggest a cash upfront license fee payment since the remainder of the compensation in the form of the running-royalty substitute will be in the form of stock or options (which may turn out to be worthless if something happens to the licensee). The real challenge then comes in structuring the running-royalty substitute.

As an overview, the running-royalty substitute should provide a mechanism to coarsely track the successful commercialization of the licensed patent by the licensee. Accordingly, a straight one-time grant of issued stock to the licensor might be too disconnected from the success of the commercialization as the licensee's stock may appreciate in value for wholly other reasons than the successful commercialization of the licensed patent. For example, the licensee may well have other proprietary technologies that it is developing, and it may be these that lead to increased valuation of the licensee's stock at any given time. From the licensee's perspective, a one time grant of issued stock is further problematic in that it will have immediate dilutive effect on the equity positions of other investors, many of whom specifically negotiated for a specific percent ownership stake in the company. This will be especially true where the parties have agreed to a fairly high expected value for the term of the licensed patent and thus a relatively large number of shares would have to be issued and immediately transferred to the licensor upon execution of the license.<sup>283</sup>

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283. Note that the per share price of the licensee's stock is itself an estimate, particularly where the company is still privately held. The parties could look to the per share price of the last negotiated private placement of the company's stock, but even this may not be an accurate measurement if the shares placed in the private placement were preferred shares with specific (and valuable) rights and preferences that might differ from the rights and preferences of the preferred shares to be issued to the licensor, and will almost certainly differ from the standard rights assigned to common stock. As a general matter, though, the price per share of the stock of early stage tech SMEs is not going to be that high. Therefore, if the expected lifetime value of the licensed patent is high, say \$1M, then it will take quite a number of shares to compensate the licensor adequately. For example, say that the

The parties should use some combination of stock and stock options instead, to more closely approximate the expected royalty payments in a traditional running royalty license. The parties must agree upon verifiable events that correspond to successful sales of licensed products to be used as conditions precedent to the exercise of stock options granted at the time of execution of the license.<sup>284</sup> In the most direct coupling, stock options could be set up that allow some number to vest, and thus become exercisable, per certain numbers of licensed products sold. While options often have a “strike price” – a fixed amount at which the option holder is entitled to buy some number of shares of the option issuer regardless of the fair market value of the shares at the time of option exercise and purchase<sup>285</sup> – in my proposal the strike price

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licensee’s shares are estimated at \$10 per share (not unusual in my experience), then the licensee would have to issue 100,000 shares to the licensor. Of course, the licensee could argue that its share price is likely to increase over the term of the patent (and license), and thus the licensor should accept fewer shares inversely proportional to this expected increase in the price per share. Further, the licensee could argue that its position is no more speculative than the calculation of the expected lifetime value of the licensed patent. Nonetheless, even with some discounting of the number of shares to be transferred as payment to the licensor, the total number will likely still be sufficiently high to concern other investors, such as venture capitalists, who are keenly aware of, and protective of, the relative percentage ownership stake of their holdings and any possibility of dilution.

284. Stock options are generally set up as legally binding contracts that give the recipient a right to buy (“call option”) or sell (“put option”) a given stock. Sometimes options conveyed directly from the issuer are called “warrants”. See, e.g., LARRY D. SODERQUIST, *UNDERSTANDING THE SECURITIES LAWS* § 3.2.2(D) (4th ed. 2005).

285. This may be because many options are “purchased” for less than the value of the underlying stock being optioned, thus the option holder has agreed to pay some further consideration to actually buy the optioned stock. This may be more readily accessible in the guise of, say, an option by a movie producer for the rights to make the movie version of a popular book. The producer is not ready to fully commit to pay the full agreed upon value of the movie rights, but wants to essentially buy some time in which to decide whether to commit. Absent an option, he could lose the rights to another producer who is ready to contract to purchase the rights. The first producer, then, instead buys an option – in other words, he pays the book’s copyright owner a negotiated sum for the latter to “take the movie rights off the market” for some period of time. At the end of the option period, the producer needs to exercise the option and commit to buying the full movie rights or lose his exclusive option. If he lets the option lapse, he may still, of course, buy the movie rights at any later time, provided they are still availa-

would likely be zero, or the option phrased so as to make clear that the licensor as option holder essentially has a demand right to receive  $x$  number of shares with no further payment. If for some reason this “zero strike price” or perhaps “fully paid-up demand right” was deemed to be insufficient consideration for the ultimate conveyance of the actual issued shares, then a nominal strike price could be added to the option agreement.<sup>286</sup> However, in that case, the strike price would have to be offset by additional option grants, or perhaps even a proportionally greater up-front cash or stock payment.

The key difference between this option or warrant structure and running royalty license payments would be that the options would vest under their own contractual terms – ideally executed in a separate contract – which would not formally be part of the license agreement (although probably referenced therein) and hence not subject to cancellation or repudiation based on patent challenges. The options themselves could be styled as either an up-front royalty payment that would fully satisfy the licensee’s royalty obligations under the license

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ble. Thus, the payment for the *option* and the payment for the *movie rights* are two different negotiated deals, and no one would normally think that the purchase of the option would be adequate consideration to actually also acquire the movie rights. In the securities context, options are often used to lock in a certain price of otherwise fungible shares of the issuer. But a similar distinction exists between the payment required to secure this option, and the final payment to buy the shares themselves. As a side note, the saying that options are “under water” is used to describe a situation where the current fair market value of shares of the option issuer is less than the strike price the options holder was granted in his options award/agreement. Thus, the option is worthless to the holder at that point because she could buy shares directly from the company or in the secondary markets, as applicable, for less than she would have to pay to buy them under her option grant.

286. While I have yet to see an adequate explanation of the distinction between stock “options” and “warrants,” it could be that the warrant model is more congenial to the zero strike price/fully paid-up demand right I envision. In my experience in private practice, “warrants” were used for investors who were purchasing shares but wanted a further option to buy more shares at a future date, while “options” were used for employee (including executive) and director inventive compensation packages. This sense of “warrants” does seem to comport with one treatise writer’s passing reference to the same. See LARRY D. SODERQUIST, *supra* note 284. For a complementary definition of “warrants,” see 17 C.F.R. § 240.12a-4 (2006) (exempting certain warrants from Section 12(a)).

agreement, or as another license fee.<sup>287</sup> Given that there will likely be a true up-front license fee paid in cash or issued stock as described above, it may be confusing to label the “back end” running royalty replacement options as another license fee. Further, since the option payments considered here are truly supposed to replace the running royalties, and given that royalties can indeed be paid up front or at any time in a lump sum upon agreement of the parties, it is probably best to label the option payments as a one time, fully compensating, royalty.

A possible problem with the straightforward coupling of options vesting with actual sales of the licensed product is that the licensee may simply not be very forthcoming with this information, particularly if it is contemplating challenging the underlying patent. Of course, in most well-drafted running royalty agreements there is a reporting requirement for the licensee to give a relatively detailed account of how it arrived at the amount of the royalty it is paying to the licensor for any given royalty period as set out in the license agreement.<sup>288</sup> Yet, it is not hard to imagine that licensees may be tempted to fudge these numbers a bit. Therefore, many running royalty license agreements also include an audit provision that grants the licensor the right to inspect the books and records of the licensee at certain times to verify whether the reported royalties were correctly calculated.<sup>289</sup> However, these reporting obligations and audit rights may not be particularly effective where the licensee is going to try to challenge the patent per *MedImmune*. This is not to say that the provisions will be any less binding, or that they will be disregarded, in a declaratory judgment patent challenge action. Rather, the point is that if the licensee is actively trying to blow up the underlying patent, it may be in no mood to accurately calculate and pay royalties, nor to allow in the licensor’s accountants when the licensor attempts to exercise its audit rights. Certainly these actions might be deemed as license agreement breaches in their own right – and thus perhaps allow the patent owner/licensor to

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287. In the former, the license grant would read something like “licensor hereby grants licensee a fully paid-up license. . .,” while in the latter it would be “licensor hereby grants licensee a royalty free, fully paid-up license. . .” See, e.g., NGUYEN ET AL., *supra* note 8, at 113-17.

288. See *id.* at 117-120.

289. *Id.*

counterclaim on these grounds in the declaratory judgment action – but the net result will still likely be the same. The licensee may continue underreporting sales and blocking the licensor's audit attempts during the pendency of the declaratory judgment action and thus the stock option royalty payment plan I am proposing might not be significantly more effective than a regular running royalty payment plan.<sup>290</sup> Note that this story would change dramatically where the licensee is a publicly traded or other reporting company that must fulfill the mandatory disclosure requirements promulgated under the Securities Exchange Act of 1934.<sup>291</sup> In that case, potentially substantial penalties and liabilities could attach to the licensee for any material misreporting of its sales information in the financial statements accompanying its annual or quarterly reports.<sup>292</sup>

To be on the safe side, licensors might instead tie the options vesting to different sorts of events, more easily verified from a distance. Further, from my own experience, many tech transfer licensing deals also contain some kind of extra compensation to the licensor when certain milestones are met by the licensee, such as the successful filing of a New Drug Application (NDA) with the Food and Drug Administration (FDA). Sometimes the milestones instead work as a prod to the efforts of the licensee in that a missed milestone may allow the licensor to terminate the license. Thus, in my proposal, licensors could tie options vesting to any of these sorts of milestone events, perhaps in addition to vesting directly coupled to sales figures. In the most difficult to monitor situations, licensors may instead simply establish a time based vesting schedule (similar to how most employee stock options vest), which could mimic the well-established use of "minimum royalties"

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290. Balancing this somewhat is the marketing and promotion pressure the licensee may feel to accurately report its sales publicly. However, such a public pronouncement could be suitably rosy and vague such that the licensee may be able to have it both ways: underreporting sales to the licensor *and* crowing about how good its business is going to the press. Further, it is possible that other investors, such as venture capitalists, are receiving accurate numbers from the licensee and would be willing to share them with the licensor. I am not overly optimistic about that possibility, though, and certainly I know of no general obligation on shareholders to share information with other shareholders in privately held companies.

291. See 15 U.S.C. §§ 78l, 78m & 78o (2000).

292. See, e.g., 17 C.F.R. § 240.10b-5 (2006).

clauses in standard running royalty license agreements.<sup>293</sup> In minimum royalties arrangements, the licensee must pay some minimum amount each year, regardless of whether any products are sold under the license, just to retain the license grant. This again underscores the notion that licensors are free to request almost any sort of payment structure as “royalty” for licensees use of the licensed patent. In fact, reviewing the early licensee estoppel cases above, it is clear that the use of sales based royalties developed somewhat later than the traditional use of fixed one time, annual or other periodic, royalty structures. The challenge of minimum royalty provisions is especially acute for SME tech start-ups who are often cash-starved and “living” on their VC and other investors periodic infusions of capital. For these companies, every extra fixed cost that accrues in the pre-product or pre-revenue period increases the risk that the company will flame out before making it to market with a product. This sort of scenario can lead to license arrangements where there is little to no minimum royalties in the first few years of the license, but then the minimum royalties ratchet up over time,<sup>294</sup> in part to give strong incentive to the company to not dally in its efforts to get a product to market and begin generating revenues.

Accordingly, licensors under my proposal may seek to obtain a number of different stock option grants with different vesting triggers or conditions. In the alternative, the options could all be granted in one agreement, but with a complicated set of vesting schedules and conditions. With luck, in the aggregate, the regular vesting of options on different schedules and conditions over time, should roughly map the success of the licensee in commercializing the patent. Further, it may make sense for the licensor to secure some number of fully issued shares in the early days of the license as a backstop hedge against a licensee who winds up acting in very bad faith and refuses to honor the licensor’s attempt to exercise fully vested options at some point in the future.<sup>295</sup>

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293. See NGUYEN ET AL., *supra* note 8, at 113-17.

294. *Id.*

295. Again, I think the risk of this is fairly low, in that it would be a financial suicide move for the licensee as soon as the story got out to other investors and the capital markets.



So far, this all sounds promising. However, as discussed in Part IV(A) above, investors who hold unregistered or restricted stock hold a fairly illiquid investment. Further, in the case of tech SMEs, this investment is quite risky too, as many of these ventures fail. Thus, the fear of getting locked into a risky, failing investment should be a real one for patent owners looking to implement my proposal. For some of these patent owners, such as universities, this may not present as much of a problem as it would for others, such as individual inventors, in that the universities do not need or expect to make money off every patent they license – indeed, some universities are not even mandated to maximize returns on patents, but rather are supposed to be engines of local economic development or assist the overall university mission of information dissemination. The individual investor, by contrast, may view his patent as his sole chance to make a living off his inventions, and must also diversify his investment portfolio, which will be harder to do if the lion's share of his income is in the form of restricted stock in a risky SME.

There is a further concern for my proposal, even for universities that can manage the risk of an illiquid investment in a risky SME, which is that universities and other research organizations might not want to be in the business of holding an increasing securities portfolio (outside of its regular endowment investments that is). There are a couple of disparate reasons for this. First, because the university will generally be holding and licensing patents on inventions created by their own faculty researchers, real or perceived conflicts of interest can arise, especially where there is an ongoing relationship between the faculty researcher and the outside licensee. Similar to the scandal that ensued at the University of Pennsylvania when a clinical research subject, Jesse Gelsinger, died in the middle of a gene therapy clinical trial for a outside biotech company that the faculty researchers held stock in, university holdings of stock in outside companies that are linked to the university can raise serious ethical questions.<sup>296</sup> Second, because many universities share some portion of licensing reve-

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296. See PATRICIA KUSZLER ET AL., *GENETIC TECHNOLOGIES AND THE LAW* 381-416 (forthcoming 2007).

nues with the faculty inventors,<sup>297</sup> the universities must take care not to get caught under the securities law definition of underwriters involved in a unregistered securities distribution where they receive restricted securities from the licensee and then convey some of the shares to the faculty inventors.<sup>298</sup> If the licensee is already publicly traded and “pays” the royalties with registered stock or options for the same, then this problem is greatly reduced. However, because many tech transfer deals will involve privately held SMEs as licensees, then the securities used to “pay” the royalties will likely be restricted stock. One avenue around this, similar to the liquidation discussion to be taken up below, is for universities to refrain from conveying the restricted stock to the faculty inventors until such time as it has been converted into common stock and registered for trading in the public capital markets. Alternately, the university could find a way to cash out a portion of its holdings in the licensee – through a resale of restricted securities under Rule 144 or Rule 144A as described in Part IV(A) above – and then simply pay cash to the faculty investor.

The response to the foregoing concerns might not be for universities and other research organizations to shy away from my proposal, but rather to focus on ways to liquidate and diversify their holdings in SME restricted stock as soon as possible. As mentioned above, this will follow two major paths: i) registration of restricted stock to trade in the public capital markets as soon as possible after an IPO of the licensee; or ii) resales of the restricted stock under Rule 144 or Rule 144A as soon as practicable. This does not mean that the licensors should divest themselves of *all* restricted shares received from licensees, but rather only as much as needed to meet other goals such as proper diversification of investments and to secure cash or publicly tradable securities to transfer to faculty inventors for their portion of licensing revenues. In fact, it is probably desirable for licensors to continue holding at least some of the licensee’s stock because, so long as the licensee continues to seem promising, its stock may eventually provide

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297. In fact, if federal funding was involved in the research that led to the patent, then under Bayh-Dole, the university must share licensing revenues from that patent with the inventor. *See* 35 U.S.C. § 202 (2000).

298. *See* 15 U.S.C. § 77b(a)(11) (2000) (defining “underwriter” under the Securities Act of 1933).

a tremendous return on investment as one of those “home run” success stories that does happen here and there. To effect (i) above, the licensor must secure “registration rights”<sup>299</sup> in the stock or stock option conveyance agreements. These rights will, at a minimum, give the licensor the right to demand that its shares are registered in some kind of follow-on offering shortly after the IPO;<sup>300</sup> at their maximum, these rights can give the licensor the right to demand that the company take all steps possible to effect an IPO and register the licensor’s shares as part of that IPO or a quick follow-on offering.<sup>301</sup> To effect (ii) above, the licensor needs to follow the dictates of Rule 144 or Rule 144A, as applicable, which is a discussion beyond the scope of this Article. The upshot though is that for resales of restricted securities, the licensor must avoid being deemed an “underwriter” by complying with either: a) Rule 144’s conditions such as a one year holding period before resale, limitations on how much stock can be sold, and limitations of sales to brokers’ transactions or with a market maker;<sup>302</sup> or b) Rule 144A’s primary condition that the resale be made only to a “qualified institutional buyer” as defined therein.<sup>303</sup>

In the end, while the processes may be tricky, and the risks of perception issues such as conflicts of interest increased, my proposal will allow non-commercializing patent owners such as universities to minimize the risk of royalty payment “defaults” by licensees who decide to challenge the underlying patent in the wake of *MedImmune*. At the same time, if done creatively, stock and options up front royalty payments will coarsely mimic the returns of running royalty license agreements, “unlocking” equity value for the licensor at various steps along the way. This should effectively offset the po-

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299. See Miller et al, *supra* note 266 § 3:17.

300. The licensor must also make sure that if it does not hold common stock of the licensee, then it must hold convertible preferred stock that either converts into common automatically upon the IPO or is convertible upon demand of the licensor. Licensors must watch the conversion formulas or rates used to convert preferred shares into common shares as the conversion will in many cases not be a simple one-for-one process.

301. See Miller et al., *supra* note 266 § 3:17.

302. 17 C.F.R. § 230.144 (2006).

303. 17 C.F.R. § 230.144A (2006).

tential damage to licensor-licensee relationships and prospective deals unleashed by *MedImmune*.

One might argue the equities from the licensee's perspective, though, and feel that my proposal somehow disadvantages the licensee. It is "paying" for a license that it may not be using or that has been terminated or repudiated, or in which the underlying patent has even been invalidated. The first answer is that this is how it has always been with licensing, despite the Supreme Court's frequent misapprehension about it: a licensee is only buying a covenant not to sue from the licensor, because it believes the licensor *may* be able to sue him now or sometime in the future. There may come a time when it is no longer true that the licensor can sue him – *e.g.*, the underlying patent is invalidated – but this only impacts an ongoing payment structure, not past payments already made. In other words, as mentioned above, I have never heard of a court ordering repayment or refund of paid royalties of up front license fees or royalties just because a license was terminated or a patent invalidated. Ultimately, the arrangement is equitable because, as I discussed earlier, the licensee has often received a substantial market benefit from the license even if the underlying patent is ultimately challenged. This is particularly true in exclusive license situations. Thus, it would constitute an impermissible windfall for licensee to be able to require a refund of licensee fees or royalties from licensor for the period before the patent was challenged and during which licensee had all the market benefits and pricing power of an exclusive right to the patent.

Another factor that assists the licensee, under my proposal, is that the licensee is able to get a valuable license in exchange for what sometimes is thought of as the funny or free money represented by stock. Stock grants are not actually a free ride when thought of in terms of ownership stake and dilution of other ownership stakes. Plus as stock grants dilute pre-existing ownership stakes they changes the control of the company. Further, unless the licensor receives only some sort of non-voting stock, then it will have all the voting rights of other shareholders. But, outside of this, the use of stock eliminates the need for the company to part with cold hard cash either upon execution of the license or in the future for royalty payments. In exchange the company's owners only lose some control. The licensor needs to make sure that it will be

able to liquidate all or some of the stock position as it needs to, and this will require some better knowledge of securities laws.

Ultimately, my proposal has equities for both licensor and licensee. While it may not perfectly mimic the projected (or actual) returns of a running royalty license, it may still offer some extra value for licensors and licensees generally. Finally, to the extent it prevents a socially undesirable downward spiral in deal licenses – especially those of universities and other non profits as described above – then it will have served an enormous purpose.

## V.

### CONCLUSION

This Article has given a rough taxonomy of the many different kinds of licenses and motivations of the licensing parties. The taxonomy allowed us to review the extensive and convoluted history of judicial doctrine with regard to licensing, in particular the doctrines of licensee estoppel, assignor estoppel, and the application of the general doctrine of res judicata to the world of settlement licenses. Following some critically reviewed Supreme Court cases including *Lear*, the Article then analyzed the *MedImmune* decision and the current controversy surrounding it, arguing that there are some serious flaws in the outcome. Nonetheless, because of the finality of Supreme Court holdings, the Article moved on to propose a system that is harmonious with *MedImmune*, and *Lear* for that matter, yet allows licensors to put in place a functional equivalent of the standard royalty payment models that is not subject to the same payment risks as those royalty models are, especially in the wake of *MedImmune*. In conclusion, I believe that this Article provides a path to rebuild the solid, profitable, and socially useful system of license relationships that has been very nearly destroyed by *MedImmune*. Without it, we may well see the decay of some of our most valuable science, medicine, and technology R&D pathways that rely on technology transfer from universities and non-profit research centers to the private sector for commercialization.